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TAX TREATMENT OF HOSTILE TAKEOVERS

HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ON

S. 420, S. 476, and S. 632

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TAX TREATMENT OF HOSTILE TAKEOVERS

MONDAY, APRIL 22, 1985

U.S. SENATE,
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT,
COMMITTEE ON FINANCE,
Washington, DC.

The subcommittee met, pursuant to notice, at 9:31 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable John H. Chafee (chairman) presiding.

Present: Senators Chafee, Danforth, Long, Bentsen, Boren, and Pryor.

[The press release announcing the hearing, the Joint Committee on Taxation staff report, and Senator Chafee's and Senator Boren's opening statements follow:]

[Press Release No. 85-013]

COMMITTEE ON FINANCE SETS HEARING TO CONSIDER TAX TREATMENT OF HOSTILE TAKEOVERS

Senator Bob Packwood (R-Oregon), Chairman of the Committee on Finance, announced today the scheduling of a hearing of the Subcommittee on Taxation and Debt Mangement on the tax treatment of hostile takeovers.

The hearing is scheduled to begin at 9:30 a.m., Monday, April 22, 1985, in Room SD-215 of the Dirksen Senate Office Building.

Senator John Chafee (R-Rhode Island), Chairman of the Committee on Finance's Subcommittee on Taxation and Debt Management, will preside at the hearing.

The bills to be considered include:

S. 632.—Introduced by Senator Chafee. S. 632 would require a mandatory Section 338 election in the case of hostile stock purchases. It also would deny a deduction for so-called "greenmail" payments (i.e., payments made by a corporation in connection with a takeover attempt of that corporation to certain shareholders in exchange for their stock) and interest on indebtedness incurred in certain hostile takeovers.

S. 420 and S. 476.—Both introduced by Senator Boren (D-Oklahoma) and Senator Nickles (R-Oklahoma). S. 420 and S. 476 would deny a deduction for interest incurred in certain hostile takeovers, impose an excise tax on greenmail profits and require a mandatory Section 338 election in certain hostile stock purchases.

FEDERAL INCOME TAX ASPECTS OF HOSTILE TAKEOVERS AND OTHER CORPORATE MERGERS AND ACQUISITIONS (AND S. 420, S. 476, AND S. 632)

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON
TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

ON APRIL 22, 1985

PREPARED BY THE STAFF OF THE

JOINT COMMITTEE ON TAXATION

INTRODUCTION

The Subcommittee on Taxation and Debt Management of the Committee on Finance has scheduled a hearing on April 22, 1985, on Federal income tax aspects of hostile corporate takeovers. This pamphlet,[1] prepared in connection with the hearing, provides a description of many of the Federal income tax considerations relevant to corporate takeovers generally and, therefore, to hostile takeovers as well.

The first part of the pamphlet contains an overview. The second part generally discusses tax policy issues raised by applicable and proposed tax rules. Part three describes the hostile takeover and, in simplified form, common forms of acquisition transactions, and part four contains a more detailed and technical articulation of the tax rules generally applicable. The fifth part describes 3 Senate bills (S. 420 and S. 476, introduced by Senators Boren and Nickles and S. 632, introduced by Senator Chafee) that have been introduced recently relating to tax consequences of hostile takeover activity.

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[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Federal Income Tax Aspects of Hostile Takeovers and Other Corporate Mergers and Acquisitions (and S. 420, S. 476, and S. 632)* (JCS-9-85), April 19, 1985

I. OVERVIEW

The United States is presently in the midst of what appears to be the fourth major merger[2] wave since the turn of the century (see Table 1). Like the current merger wave, previous merger booms occurred during strong stock market upswings.[3] Merger waves are thought to be related to a variety of economic factors including stock market fluctuations, advances in production and distribution

Table 1.—Mergers and Acquisitions, 1968–84

[Dollar amounts in billions]

Year	Number of transactions[1]	Value of consideration exchanged[2]	
		Nominal dollars	Constant (1983) dollars
1968	4,462	43.0	112.2
1969	6,107	23.7	58.8
1970	5,152	16.4	38.6
1971	4,608	12.6	28.3
1972	4,801	16.7	36.0
1973	4,040	16.7	34.0
1974	2,861	12.5	23.4
1975	2,297	11.8	20.2
1976	2,276	20.0	32.5
1977	2,224	21.9	33.7
1978	2,106	34.2	49.0
1979	2,128	43.5	57.3
1980	1,889	44.3	53.5
1981	2,395	82.6	90.9
1982	2,346	53.8	55.9
1983	2,533	73.1	73.1
1984	2,543	122.2	117.8

[1] Includes only publicly-announced transactions involving transfers of ownership of 10 percent or more of a company's assets or equity, provided that the value of the transaction is at least $500,000.

[2] Includes only those transactions for which valuation data are publicly reported.

Source: W.T. Grimm & Company and Council of Ecomonic Advisers.

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[2] Under the Internal Revenue Code, "merger" is a term of art, referring to certain kinds of combinations of the one corporation with another on a tax-free basis under section 368(a)(1)(A). In this pamphlet, the term generally (except in part four) is used in a non-technical sense to refer to any acquisition or takeover of one corporation by another corporation or other person.

[3] F. M. Scherer, *Industrial Market Structure and Economic Performance*, 1970. Scherer identifies merger waves up to 1970; 1887–1904, 1916–1929, and the post-World War II recovery through 1970.

technology, and changing demand conditions. In addition, merger activity is indirectly influenced by the tax system and is directly regulated by the Federal Trade Commission, the Justice Department, the Securities and Exchange Commission, and other agencies.

The current upsurge of merger activity has received considerable publicity because of the unprecedented size of the corporations that have been acquired and the costly and novel defensive and offensive strategies that have been pursued in connection with hostile takeover attempts. Some have expressed concern that the $122 billion spent on mergers and acquisitions last year diverted corporate resources and management attention away from more productive internal investment opportunities and managment responsibilities. Others contend that the threat and conduct of takeovers is socially beneficial because management is forced to maximize the value of corporate assets or risk losing operating control. Still others contend that if large amounts of the nation's wealth are to trade hands through mergers and acquisitions which are at least partly influenced by the tax system, then the tax system should encourage those transactions to be structured in such a way that employees of the affected companies have an opportunity to gain a stock ownership interest. However, one thing is clear: the effect of tax and regulatory policies on the market for corporate control is an issue of significant economic and political consequence. The market value of the securities issued by publicly-traded corporations accounts for over 20 percent of the nation's wealth.[4]

Certain features of the corporate and individual income tax (as well as of the estate and gift tax) may affect the attractiveness of takeovers from the standpoint of both the acquiring and target corporations and their shareholders. The Tax Code may be harmful to economic growth if tax considerations encourage inefficient, or discourage efficient, changes in the ownership of corporations or their assets.

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[4] *Annual Report of the Council of Economic Advisers* (February 1985).

II. TAX POLICY AND THE MARKET FOR CORPORATE CONTROL

The tax Code influences corporate acquisitions directly through rules governing the sale or other disposition of corporate stock or assets and indirectly through the general rules pertaining to the taxation of corporate and individual income and of estates. The interaction of these tax rules may affect the number of acquisitions, the form of an acquisition, the type and amount of consideration paid, the number of taxpayers who may benefit from an acquisition, the tactics used in takeover contests, and the corporations that are candidates for becoming acquirers or targets. The organization of this part is as follows: first, relevant tax rules are summarized; second, the effect of those rules on the form and substance of takeover activity is analyzed; third, the policy implications of tax-motivated or tax-supported takeover activity are assessed; and fourth, some proposals for change in rules applicable to hostile takeovers and hostile takeover attempts are described.

A. Summary of Tax Rules

The Code generally does not distinguish between friendly corporate acquisitions and hostile ones. There are not special Code sections which explicitly apply only in a hostile case or only in a friendly case. With rare exception, therefore, the Code neither encourages nor discourages a hostile, as opposed to a friendly, acquisition.[5] As a result, to the extent the Code subsidizes corporate acquisitions, it subsidizes hostile ones as well as friendly ones. The general rules must be understood.

Three features of the Federal income tax appear to have the most significant effect on the pattern of takeover activity: (1) the differing tax consequences of acquiring an entire corporation versus acquiring individual corporate assets; (2) the disparate treatment of corporate "distributions" made in the form of interest, dividends, and long-term capital gains; and (3) the inability of corporations with limited taxable income to take full advantage of business tax preferences. These and other aspects of the tax rules are described below.[6]

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[5] Two provisions of the Deficit Reduction Act of 1984 might be viewed as indirectly favoring friendly acquisitions. These are section 246A (denying the dividends received deduction with respect to dividends received on debt-financed portfolio stock) and the new golden parachute rules (secs. 280G and 4999).

[6] Takeover activity is also influenced by the ability of corporations to obtain financing on favorable terms as, for example, if the financing is structured in such a way that employees gain a stock ownership in their employer corporation through an employee stock ownership plan ("ESOP").

1. General provisions of the corporate income tax

Income from corporate assets that is paid to noncorporate debtholders is not taxed at the corporate level since interest payments generally are deductible for purposes of computing taxable income. Conversely, corporate income paid out as dividends is subject to corporate-level tax since dividend payments are not deductible by a corporation. Thus, the combined individual and corporate tax on debt-financed investment is no more than 50 percent (the top individual rate), while the combined tax on income distributed from equity-financed corporate investment is as high as 73 percent (assuming a 46-percent corporate rate).[7] As a result, the after-tax return on a dollar of income on debt-financed assets (50 cents) is, at the highest tax rates, almost double the return on a dollar from equity-financed corporate investment (27 cents). A company with a high debt-to-equity ratio may have a tax advantage over a similar company with little debt financing. Debt-financed takeovers effectively increase the debt-to-equity ratio of the acquired corporation and thus may increase share price to the extent that the tax advantages of debt financing are not outweighed by the disadvantages (e.g., increased bankruptcy risk.)

Under current law, a substantial percentage of the economic income of many corporations escapes corporate income tax as a result of various business tax preferences provided by the Code. Examples of these preferences include the investment tax credit and accelerated depreciation. These preferences cannot be used on a current basis by corporations that do not have sufficient taxable income in the current or prior 3 years. Such corporations can carry forward (up to 15 years) net operating losses and excess credits until current taxable income is sufficient to absorb them.[8] Companies in a carryforward position are often at a tax disadvantage relative to companies that have sufficient taxable income to use available tax preferences currently.[9] Thus, there is a tax incentive for structuring mergers which effectively permit more rapid utilization of current preferences and carryforwards.[10]

2. General provisions of the individual income tax

Shareholders are taxed on the income from corporate assets only when it is distributed as a dividend or when gain is realized from a sale or other disposition of their shares. Thus, shareholders generally can defer tax on corporate income that is reinvested rather than distributed as a dividend. These rules may lead to large accumulations of undistributed corporate income and attract takeover attempts.[11] If reinvestment opportunities are limited, management may decide to use retained income to acquire control of another corporation, lest their own corporation be subject to a similar fate. Alternatively, retained earnings might be used by the corporation to redeem or repurchase its own shares; however, management may prefer to expand the size of the corporation through acquisition rather than shrink it through redemptions of shares.

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[7] In this case, $100 of corporate income is subject to $46 of corporate income tax, and the remaining $54 of after-tax corporate income is subject to up to $27 of tax at the shareholder level when distributed. The maximum combined tax is $73 ($46 plus $27).

[8] A corporation experiencing a real economic loss will likely have NOL and foreign tax credit carryovers even in the absence of tax preferences. However, the prevalence of corporate tax preferences greatly increases the likelihood that even a profitable corporation will be in a carryforward position.

[9] Corporations may seek to absorb their NOLs by the sale and leaseback of their assets, by recognizing built-in gains, or by other transactions. However, these transactions may be costly or unavailable.

[10] Use of NOLS, excess credits, and built-in losses following an acquisition is limited by Code sections 382, 383, and 269, among others, by the consolidated return regulations.

Individual shareholders are taxed at ordinary income rates, of up to 50 percent, on dividends paid out of corporate earnings. However, individuals are taxed on only 40 percent of long-term capital gains from the sale or other disposition of stock (as a result of the 60 percent long-term capital gain deduction). Consequently, the effective rate of tax on long-term capital gains of individuals is no more than 20 percent. Further, because of the step up in basis of property at death, some gain is not taxed at all. Thus, the Code creates an incentive for corporate transactions and financial policies that produce capital gains, whether currently taxable or deferred, rather than dividends for individual shareholders.

3. General provisions of the estate and gift tax

Federal estate tax generally applies to the transfer of property at death. In general, the estate tax applies equally to transfers of shares in closely- and widely-held corporations, although, in practice, there are differences. First, the valuation of shares in a closely-held corporation is less certain, so the amount of estate tax that will be assessed by the Internal Revenue Service is more difficult to predict. Second, shares in closely-held corporations are less liquid. This may make it difficult for the executors to dispose of stock in order to pay estate taxes and other expenses. These considerations may lead a shareholder in a small corporation to sell his shares or exchange them in a tax-free reorganization for shares in a publicly-traded corporation. However, the Code does contain a number of provisions which mitigate the estate-tax disadvantages of holding shares in closely-held corporations and, as a consequence, reduce the incentive to merge solely for estate tax purposes.[12]

4. Income tax treatment of acquisitions

The Code distinguishes among taxable purchases of corporate stock, taxable purchases of corporate assets, and tax-free reorganizations for income tax purposes (see Table 2). The applicable tax rules have been criticized on the grounds that economically similar acquisition transactions have different Federal tax consequences depending on their legal form.

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[11] Section 531 (relating to unreasonable accumulations) and other sections seek to limit the excessive accumulation of corporate earnings.

[12] Section 6161(a)(2) provides for an extension of time in the payment of estate tax under certain conditions. See also section 6166. Section 303 provides exchange rather than dividend treatment for redemptions of certain stock included in an estate in an amount up to the amount of estate taxes and administrative expenses. In addition, the Economic Recovery Tax Act of 1981 liberalized the estate and gift tax. See Alan L. Feld, *Tax Policy and Corporate Concentration* (1982), pp. 97-99. The Deficit Reduction Act of 1984 added several provisions to the Code concerning employee stock ownership plans that also reduce the incentive to merge solely for liquidity or estate tax purposes. See section 2210 (payment of estate liability by ESOPs), section 1042 (tax-free rollover on sale of stock to employees), and section 133 (partial exclusion of interest earned on ESOP loans). See also sections 404(a)(9) and 409 (relating to ESOPs).

Control of a corporation's assets can be obtained either by acquiring the assets of the target corporation from the target corporation or by acquiring its stock from the target's shareholders. Generally, the sale of assets by a corporation in a taxable transaction results in the recognition of gain (or loss) to the corporate seller. In addition, the buyer uses its cost for the assets for the purpose of subsequent depreciation, depletion, and amortization deductions and gain or loss computations.

On the other hand, the purchase of a corporation's assets and its subsequent liquidation pursuant to a plan of complete liquidation under section 337 generally does not trigger corporate recognition of gain (although there are exceptions for recapture and similar items) or loss.[13] Even though gain is not generally recognized to the corporate seller, the purchaser will step up the basis of the assets to their cost. A similar result is obtained by a purchase of shares followed by an actual or deemed section 338 election. If there is such an election, the target generally is treated as having sold its assets in a section 337 transaction and then reacquired them.

Alternatively, the purchase of stock of a corporation may avoid gain recognition (including recapture) by that corporation if a "carryover" transaction is chosen. In a carryover transaction, the acquired corporation retains its tax attributes (such as net operating loss carryovers, credit carryovers, and asset basis). Corporate-level carryover tax treatment is accorded in tax-free reorganizations and in taxable stock acquisitions where a section 338 election is not made or deemed made. Determining whether carryover or step-up tax treatment is more favorable requires considerable analysis, and the acquirer in a taxable stock acquisition frequently will take advantage of the time allowed by section 338(g)(1) before making a section 338 election.[14]

Table 2.—Income Tax Treatment of Corporate Acquisitions

Tax consequence	Taxable asset acquisition without complete liquidation	Taxable stock acquisition with sec. 338 election [1]	Taxable stock acquisition without sec. 338 election	Tax-free reorganization
Corporate income tax				
Recognition of gain/loss	Yes	No	Deferred	Deferred
Recapture	Yes	Yes	Deferred	Deferred
Revaluation of basis	Yes	Yes	Deferred	Deferred

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[13] Section 337 is an extension of the "codification" of *General Utilities and Operating Co. v. Helvering*, 296 U.S. 200 (1935), in section 336. *General Utilities* is often cited for the proposition that, absent a Code section to the contrary, a corporation recognizes no gain or loss when property is distributed to shareholders with respect to their stock.

[14] Under Treas. temp. regs. sec. 5f.338-1(c) (adopted November 17, 1982 and amended February 7, 1984), a section 338 election need not be made before 60 days after publication of the next set of temporary regulations under section 338.

Table 2.—Income Tax Treatment of Corporate Acquisitions—Continued

Tax consequence	Taxable asset acquisition without complete liquidation	Taxable stock acquisition with sec. 338 election [1]	Taxable stock acquisition without sec. 338 election	Tax-free reorganization
Transfer of NOLs [2]	No	No	Yes [3]	Yes [3]
Individual income tax				
Recognition of gain/loss on exchange of shares for:				
1. Cash	N.A.	Yes	Yes	Yes
2. Debt	N.A.	Deferred	Deferred	Varies
3. Stock	N.A.	Yes	Yes	Deferred

[1] The same tax results generally flow from a liquidating sale under section 337.

[2] Similar tax treatment applies to credit carryovers and built-in losses.

[3] Use of NOL and credit carryovers and built-in losses is limited by sections 382, 383, and 269, among others, and by the consolidated return rules.

The tax consequences of a corporate acquisition at the shareholder level generally hinge on whether the acquisition is structured as a tax-free reorganization and on the type of consideration received. In qualified reorganizations, shareholders of the target corporation are not taxed currently if they exchange their stock for stock in the acquiring corporation.[15] By contrast, in taxable stock acquistions and liquidating sale transactions, shareholders of the target corporation are generally taxed currently even if they receive stock in exchange for their shares (as if their shares had been sold). (But see sec. 1042.)

Under the installment sale rules, where target corporation shareholders exchange their shares for non-readily tradable term debt of the acquiring company in a tax-free reorganization, taxable stock acquisition, or liquidating sale transaction, the recognition of gain generally may be deferred until principal payments on the note are received (sec. 453). If the transaction is a liquidating sale, or if the acquiring corporation makes a section 338 election in a taxable stock acquisition, then basis in the acquired assets is revalued at the date of election taking into account the principal amount of the note, even though the target's shareholders recognize gain only as principal is amortized. In this manner, the buyer can immediately step up basis while the target corporation wholly escapes tax on gain and its shareholders defer tax on gain.

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[15] The Code provides rules governing 6 generic types of corporate reorganizations which qualify for tax-free treatment: (A) statutory mergers; (B) acquisitions of stock for stock; (C) acquisitions of property for stock; (D) transfers of assets to controlled corporations; (E) recapitalizations; and (F) mere changes in identity, form, or place of organization. (See also section 368(a)(1)(G), which relates to reorganizations involving certain financially-troubled companies).

In summary, the tax treatment of economically similar acquisition transactions depends on the legal form of the transaction. Rather than sell its appreciated property, or distribute its assets or retained earnings directly to shareholders, a corporation may achieve more favorable tax results in a properly-structured acquisition. Thus, the decision to execute a corporate acquisition, and the decision to structure the acquisition in a particular legal form, are both influenced by tax considerations.

B. Effect of Tax Rules on Merger Activity

Although takeovers are often motivated by factors other than tax, Federal tax rules do create a number of opportunities for using takeovers as tax planning devices. In this section, 4 tax planning strategies involving the use of takeovers or mergers are identified: (1) merger as a means of distributing corporate assets ("distributive" merger); (2) merger as a means of churning the tax benefits on depreciable assets ("churning" merger); (3) merger as a means of increasing debt financing ("leveraged" merger); and (4) merger as a means of transferring tax benefits ("tax benefit transfer" merger). In addition, tax barriers to takeover or merger (i.e., situations where the tax rules may inhibit merger) are also discussed.

1. Distributive mergers

The Federal income tax rules generally conform to the principle that earnings and gain are taxed both at the corporate level and the shareholder level to the extent received or accrued. However, in certain types of mergers and acquisitions, it is possible to structure transactions so as to escape, defer, or reduce the rate of taxation at the corporate level and the shareholder level, or both.

The consequences of the tax rules can be illustrated by means of 2 simplified examples involving a corporation with $100 of retained earnings in the form of cash, in the first case, and $100 of built-in (unrealized) gain, in the second case. In both cases, the corporation has a $10 basis in nondepreciable assets (e.g., land) originally purchased for $10, and there are no deductions or credits that are subject to recapture. In both cases, the market value of the corporate assets is $110: $10 of basis plus $100 of retentions or built-in gain, respectively. The corporation is subject to tax at a 46-percent rate on ordinary income and at a 28-percent rate on long-term capital gain. Shareholders, who have a $10 total basis in their stock, are subject to tax at a 50 percent rate on ordinary income and at a 20-percent rate on long-term capital gain.

In the first case, the shareholders wish to realize the $100 of corporate retained earnings (on which the corporation may or may not have paid taxes). If the corporation distributes a $100 dividend, shareholders will be liable for $50 of income tax (see Table 3). Alternatively, the shareholders might sell their stock for $110 in cash to an acquiring corporation in a taxable stock acquisition or have the corporation undertake a liquidating sale under section 337. Either case would result in $20 of long-term capital gains tax liability for the shareholders on their $100 in gain, and no corporate tax.

Finally, the shareholders might exchange their shares for $110 worth of stock in an acquiring corporation pursuant to a qualified reorganization. In that case, the shareholders would take a substituted basis in the stock received from the acquiring corporation and defer tax on their gain (perhaps forever). Thus, as shown in Table 3, the "distribution" of $100 of corporate income can have tax results ranging from $20 of deferred tax liability to $50 of current tax liability, depending on the form of the transaction.

Table 3.—Tax on the Realization of $100 of Retained Earnings

Tax	Non-liquidating distribution	Taxable stock acquisition with sec. 338 election [1]	Taxable stock acquisition without sec. 338 election	Tax-free reorganization
Corporate tax	0	0	0	0
Shareholder tax	$50.00	$20.00	$20.00	[2] $20.00
Total tax	$50.00	$20.00	$20.00	$20.00

[1] The same tax results generally flow from a liquidating sale under section 337.

[2] Tax is deferred until sale of shares and will be fully forgiven if the stockholder dies before disposing of them.

In the second case, the shareholders wish to realize the $100 appreciation in corporate assets. The corporation could simply sell the appreciated asset and distribute the net after-tax proceeds to the shareholders in an ordinary distribution. If the transaction was not structured as a complete liquidation under section 337,[16] then the appreciation would be taxed at both the corporate and shareholder levels. In that event, the sale would trigger $28 of corporate tax (assuming the asset was a long-term capital asset or a section 1231 asset), and the distributions would total $82 ($110 less $28), of which $10 would be a return of basis to the shareholders and $72 would be a nonliquidating distribution. The shareholders would be liable for $36 of tax on the nonliquidating distribution, so the total corporate and shareholder tax would be $64 (see Table 4). Alternatively, if the assets were sold pursuant to a plan of complete liquidation, corporate tax would be escaped (under the *General Utilities* doctrine and sec. 337), and the only tax would be $20 on the shareholders' $100 gain. The same tax consequences would flow from a $110 taxable stock acquisition subject to a section 338 election. However, if a section 338 election were not made, then the acquiring corporation might be willing to pay only $82 [17] for the target's shares, because the acquirer eventually will be liable for $28 of gains tax when the asset is sold. Under these assumptions, the shareholders would recognize $72 of gain ($82 less $10) and incur current tax liability of $14.40 (.20 times $72). Finally, the same tax consequences would flow from an exchange of shares worth $82 in a tax-free reorganization except that the target's shareholders could defer recognition of their gain.

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[16] This would be the case if for some reason the $100 of appreciation were distributed and later, in an unrelated transaction, a $10 liquidation distribution were made.

[17] Disregarding present value issues.

These examples show that the *General Utilities* doctrine, sections 337 and 338, and the tax-free reorganization rules create opportunities whereby shareholders can realize corporate earnings and built-in gains with less than full current taxation at both the corporate and shareholder levels.

Table 4.—Tax on the Realization of $100 of Appreciation

Tax	Taxable "asset" acquisition		Taxable stock acquisition without sec. 338 election	Tax-free reorganization
	Not liquidated under sec. 337	Taxable stock acquisition with sec. 338 election [1]		
Corporate tax	$28.00	0	[2] $28.00	[2] $28.00
Shareholder tax	36.00	$20.00	14.40	[3] 14.40
Total tax	$64.00	$20.00	$42.40	$42.40

[1] The same results generally would flow from a liquidating sale under section 337.

[2] Corporate tax is deferred until gain in assets is realized.

[3] Shareholder tax is deferred until shares are sold or forgiven if the shareholder dies holding them.

2. Churning mergers

The Code also provides some incentive for mergers designed to minimize tax on corporate assets by churning, i.e., selling property when most of its cost has been recovered through depreciation deductions. In a liquidating sale pursuant to section 337 (or in a taxable stock acquisition with a section 338 election), the buyer steps up the depreciable basis of acquired property to cost and the seller may be subject to recapture tax but not tax on other gain. For example, in the case of section 1250 property, there will in many cases be no recapture tax liability. Thus, if a target corporation that holds fully-depreciated section 1250 property is acquired in a transaction qualifying for step-up treatment, then the buyer will obtain a fresh depreciable basis, often with no tax on the seller. In this manner, the tax benefits of ACRS straight-line depreciation for real property can be magnified by the repeated churning of corporate assets. The benefits of churning can also be obtained by nonliquidating sales of assets. However, the Code favors section 337 and section 338 transactions because they frequently allow the seller to escape tax on gain.

3. Leveraged mergers

The preceding analysis has shown that mergers can be used to distribute assets from corporate solution and to churn the tax benefits of assets. A third tax-advantaged use of mergers is to increase the amount of debt in a target's financial structure ("leverage").

The advantages of debt financing can be illustrated by comparing 2 corporations with $1,000 of gross assets that are identical except for financial structure: the first is entirely equity financed; while the second is 50 percent debt financed. Both corporations earn $200 of operating income. The all-equity corporation pays $92 in corporate tax, leaving $108 of after-tax income ($200 less $92). Thus, as shown in Table 5, the return on equity is 10.8 percent ($108 divided by $1,000).

Table 5.—Effect of Debt Financing on Stock Yield

Item	All-equity corporation	50-percent debt-financed corporation
Balance sheet		
Total assets	$1,000.00	$1,000.00
Debt	0	500.00
Shareholders' equity	1,000.00	500.00
Income statement		
Operating income	200.00	200.00
Interest expense	0	70.00
Taxable income	200.00	130.00
Income tax	92.00	59.80
Income after corporate tax	108.00	70.20
Return on equity [1] (percent)	10.8	14.04

[1] Return on equity is computed as income after corporate tax divided by shareholders' equity.

As indicated, the leveraged corporation is financed by $500 of debt and $500 of stock. If the interest rate on the debt is 14 percent, then interest expense is $70 (.14 times $500). Taxable income is $130 after deducting interest expense. The leveraged corporation is liable for $59.80 in corporate tax (.46 times $130), leaving $70.20 of after-tax income ($130 less $59.80). Consequently, the return on equity is 14.04 percent ($70.20 divided by $500.00). Thus, as shown in Table 5, increasing the debt ratio from zero to 50 percent increases the rate of return on equity from 10.8 to 14.04 percent.[18]

In summary, the Code encourages leveraged acquisitions to the extent that the managers of target corporations fail to exploit fully the tax advantages of debt financing. This may occur where existing management is more financially conservative than a potential acquirer. The Code also encourages the use of debt as payment in exchange for target stock because shareholders may use the installment method of reporting to defer capital gains tax. Finally, the Code encourages "leveraged" acquisitions to the extent that the debt is repaid through the financing technique of an employee stock ownership plan. Under this technique, the acquisition leverage results in the creation of an equity interest for employees of the affected company.

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[18] More generally, the return on equity rises with increasing debt capitalization so long as the interest rate on the debt is less than the pre-tax rate of return on corporate assets.

4. Tax benefit transfer mergers

Generally, the Code prohibits the direct sale of tax benefits from one corporation to another, requiring instead that tax benefits reduce the tax liability of the corporation that generated the benefit. For example, deductions for net operating and built-in losses cannot be sold. Nor can excess tax credits. However, in certain circumstances, tax benefits can be acquired indirectly by means of a properly-structured merger. Section 269 seeks to discourage mergers designed principally for tax purposes. In addition, sections 382 and 383 and the consolidated return rules generally seek to prevent buyers from using the target's tax benefits to reduce tax liability from unrelated assets. Nevertheless, there are a number of techniques which may allow an acquiring corporation to use a target's tax benefits more rapidly than the target.[19]

5. Other tax-motivated mergers

The preceding analysis has concentrated on the use of mergers in executing tax planning strategies designed to distribute corporate income, churn tax benefits, increase debt financing, and transfer tax benefits. Tax-motivated mergers may also occur in other situations. For example, tax-free reorganizations are a useful device in estate-tax planning for avoiding the illiquidity and valuation problems associated with stock in a closely-held corporation.

The liquidity available through a tax-free reorganization may also be available to a taxpayer if the corporation in which the taxpayer owns stock establishes an employee stock ownership plan to which the taxpayer sells his stock and "rolls over" the gain tax-free into other, more liquid securities under section 1042. In this case, Code section 1042 reduces the incentive to undertake a tax-free merger solely for purposes of creating a more liquid investment.

6. Tax barriers to merger

While there are many cases in which the Code appears to encourage mergers, there are also instances where the Code inhibits the combination of assets. The Code serves as a barrier to takeover where shareholders in a potential target hold stock with substantial appreciation and the takeover is not structured as a tax-free reorganization. In this case, the exchange of stock in the target for cash or stock in the acquiring corporation generally will trigger tax on the gain built into the target stock. An otherwise economically efficient combination of assets might not take place because of adverse tax consequences. Thus, the Code may contribute to economic inefficiency not only by encouraging inefficient mergers but also by discouraging efficient ones.

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[19] For example, a company with net operating losses can acquire a profitable company and use its losses to reduce the target's tax liability. Similarly, a profitable company may acquire a target's NOLs in a qualified stock reorganization and subsequently transfer some of its income-generating assets to the target in an attempt to avoid the consolidated return rules.

C. Policy Implications of Tax-Motivated Merger Activity

The principal tax policy issues raised by tax-motivated or tax-supported takeovers or mergers appear to be: (1) whether the effect of the tax Code on the volume and type of merger activity is harmful; and (2) whether the tax Code should be used to encourage or discourage certain types of mergers or merger tactics. A related issue is whether the tax Code should include incentives to broaden the class of taxpayers whose capital ownership interests are enhanced by mergers and acquisitions to include the employees of corporations involved in such transactions.

Although there is little conclusive evidence, a number of experts have concluded that the Code has tended to increase the volume of merger activity. In one study, tax considerations were found to be the major reason for over one-fourth of the mergers during the period 1940-47.[20] This finding may be cause for concern because from the standpoint of economic efficiency, mergers undertaken for tax reasons may not be justified.

Some have argued that the efficiency gains from the current merger wave are likely to be large based on studies showing that stock prices increase substantially after merger.[21] However, it is possible that a large portion of the stock price gain is in fact due to the capitalization of tax benefits arising from the merger. Obviously, if tax benefits explain the increase in stock price, then it cannot be concluded, from this evidence alone, that mergers increase efficiency. Also, the stock market gains associated with mergers appear to be ephemeral—disappearing altogether in the year after acquisition.[22]

While acknowledging that the economy would be better off without certain tax-motivated mergers, it has been argued that mergers used as a means of selling tax attributes, such as net operating losses and excess credits, may be beneficial.[23] The argument is that entrepreneurs are more willing to undertake risky investments knowing that in the event of failure, some portion of loss and credit carryovers can be sold in a merger. However, after an investment has failed, there is generally no efficiency rationale for mergers designed to traffic in losses. Furthermore, the use of mergers to transfer tax benefits is a cumbersome and costly approach.

Others contend that, in the absence of evidence demonstrating that mergers are generally beneficial to the economy, tax policy should be "neutral" with respect to mergers and acquisitions. Mergers would in this case be based more on efficiency considerations (provided that antitrust enforcement is effective in preventing mergers that would create monopoly power) and more likely to increase productivity. However, in altering the tax Code to remove incentives for merger or takeover, caution would need to be exercised in order to avoid creating excessive tax barriers. For example, forcing recognition of gain in certain corporate acquisitions could result in a "lock-in" effect: sale of corporate assets to superior management might be discouraged by the triggering of adverse tax results.

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[20] J. Keith Butters, John Lintner, and William L. Cary, "Effects of Taxation: Corporate Mergers", Harvard Business School (1951).

[21] See *Annual Report of the Council of Economic Advisers* (February 1985), Chapter 6. These studies compare the market value of the resulting company with the pre-merger value of both the acquirer and the target.

[22] See Warren A. Law, "Testimony before the House Committee on Energy and Commerce Subcommittee on Telecommunications, Consumer Protection, and Finance" (March 12, 1985).

[23] *Annual Report of the Council of Economic Advisers* (February 1985).

In addition to being concerned about the high volume of merger activity in recent years, some believe that offensive and defensive tactics employed in takeover contests are harmful to shareholder interests and public policy goals. Bidders have been criticized for, among other things, the use of "2-tier" offers and the issuance of sub-investment grade ("junk") bonds, while defenders have been accused of using abusive tactics such as limited share repurchases ("greenmail") and lavish severance contracts triggered by takeover ("golden parachutes"). Those who believe mergers are disruptive, inefficient, or monopolistic tend to oppose the aggressive tactics used by bidders, while those who believe that mergers promote competition and efficient utilization of resources are more worried about tactics used to ward off a hostile takeover.

The tax Code appears neither to directly encourage nor discourage such techniques as the use of 2-tier offers or greenmail in hostile takeover attempts. However, by generally allowing interest to be deducted, the tax Code reduces the after-tax cost of beginning a hostile takeover attempt with borrowed funds. The Code also encourages debt-financed mergers as a result of the general tax advantages available to the debt financing of corporations and the installment method of reporting gain on shares exchanged for debt. While section 279 seeks to discourage mergers financed by convertible subordinated debentures and similar instruments, the scope of this provision is narrow. Finally, the attractiveness of golden parachutes was reduced by the Deficit Reduction At of 1984.

While the harmfulness of certain takeover tactics is a controversial issue. there are a number of possible remedies other than tax Code amendments. If it deemed it proper, Congress could amend the securities laws to regulate certain takeover tactics. In addition, shareholders can amend corporate charters to prevent management from engaging in defensive tactics that might reduce their chance to benefit from a generous tender offer. Shareholders can also challenge defensive strategies that are not in their interest through the courts.

D. Proposals for Change

Tax-motivated or tax-supported takeovers and hostile takeover attempts result from both the general rules of the Code regarding the measurement of income from capital as well as specific provisions regarding the taxation of acquisitions. A full range of proposals for change would address the root causes of tax-motivated or tax-supported mergers and acquisitions including: (1) the double tax regime; (2) the deductibility of interest; (3) business tax preferences; and (4) net operating losses and other tax attributes.

Much more narrowly, 3 Senate bills recently have been introduced (see part five) which relate only to "hostile" acquisitions. These would deny interest deductions on a broad class of debt (or all debt) incurred to finance the hostile acquisition of corporate stock or assets and impose tax penalties on payments of greenmail and other transactions. Some of these bills treat every hostile qualified stock purchase as a sale of assets by the target corporation in a transaction not protected by section 337.

Because these narrow proposals address the most glaring symptoms of the current merger boom but not a number of the root causes of tax-motivated mergers, they raise the question of whether tax-motivated or tax-supported merger activity would be reduced or, instead, alternative strategies devised for completing corporate acquisitions. For example, any junk bond rule might be fairly easily avoided. Thus, if a junk bond were defined as a bond rated at least 2 ratings below a standard, a bond rated only one rating below that standard (or not related at all) would not be a junk bond. However, to the extent any such proposal was enacted and effective, it is likely that fewer hostile takeover attempts would be commenced. Such a state of affairs might permit management of former potential target corporations to go about their business with less disruption and might have the salutary effect of reducing the benefits provided by the tax law for highly-leveraged capital structures. It might also prevent the consummation of many economically desirable corporate acquisitions. And it would tend to reduce acquisition premiums now being paid to target shareholders.

III. CORPORATE TAKEOVERS: HOW THEY OFTEN WORK

A. Hostile Takeovers

The term "hostile takeover" may be, in one significant sense, a misnomer. While there have been some exceptions, most acquisitions of publicly-held corporations that have actually occurred in recent years have ultimately been friendly ones. That is, management of the target corporation has not formally opposed or resisted the particular acquisition transaction that finally took place. However, several recent acquisitions were preceded by real or apparent acquisition attempts or threats that were resisted by management of the target corporation. Furthermore, in many of those cases, it is likely, or possible, that had no unwelcome takeover attempt been made or threatened, no ultimately friendly acquisition would have occurred. Thus, to the extent the laws (tax, securities, or other laws) encourage the commencement of hostile takeover attempts, those laws may be to some extent responsible for many of the "friendly" takeovers that have occurred.

It is often said that much of the recent corporate takeover activity is attributable to the fact that, in the case of many corporations, stock prices over the New York Stock Exchange and other exchanges do not adequately reflect the value of their underlying net assets.[24] Thus, much takeover activity commences when a potential acquiring corporation or group identifies a corporation the stock of which seems to be trading at amounts well below underlying net asset value. That corporation will be an attractive target, particularly if it does not have a few very large shareholders.

The fact that ownership interests in a corporation are represented by stock and the fact that, in the case of public companies, stock is readily obtainable over the stock exchanges make the initial steps of a hostile takeover attempt relatively simple. The potential acquiring corporation or group will easily acquire, frequently with borrowed money, up to 5 percent of the target's outstanding stock. The acquisition of up to 5 percent of the target's stock usually can be done anonymously. As a result, those purchases may in theory be made without significantly affecting the stock exchange price for the target's stock. Thus, the would-be acquirer cannot only commence a takeover but it can commence it at what it views as a depressed price. If the acquirer is correct in its belief that its initial stock purchase has been at bargain price, it will make a substantial profit—even if it acquires no more target stock—so long as somebody completes an acquisition of the target. While the character of any such profit may be an open question in some cases, presumably most taxpayers report it as capital gain.[25] Thus, subject to section 163(d) (relating to limitations on the deductibility by taxpayers other than corporations of interest on investment indebtedness) and other sections, the acquirers will generally deduct against ordinary income interest on indebtedness incurred to purchase stock that generates tax-favored long-term capital gain.

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[24] For those concerned with takeover activity, one of the most important questions to ask is why stock market prices are low in comparison to underlying asset value. The tax-writing committees may ask whether the Federal tax laws provide at least some of the answer. Many attribute at least some of the value differential to the double tax system. Thus, for example, assume that a corporation pays significant Federal income taxes. In theory, those payments will reduce the corporation's after-tax cash flow and, therefore, the capitalized value of that cash flow. If an acquirer can reduce or eliminate the target's tax liability, without expending extra cash, the target's cash flow, and, therefore, the value of that cash flow, will increase.

Once the would-be acquirers have acquired 5 percent of a target's stock, they are generally required to make a filing with the Securities and Exchange Commission under the Williams Act (amending section 13(d) of the Securities and Exchange Act of 1934). The Williams Act filing is a public disclosure document. In it, the acquirers of the 5 percent are required to disclose, among other things, their current holdings in the target and their future plans with respect to the target. Thus, for example, the filing may disclose that the acquirers plan to attempt to acquire the target on stated terms. The filing is to be updated as appropriate.

In general, the first Williams Act filing is not required until 10 days have passed since the acquirers first achieved a 5-percent position. Thus, the acquirers may be able in that 10-day period to increase their holding in the target anonymously, i.e., at pre-existing "bargain" prices. However, once a Williams Act filing has been made (and often before that), the "market" will realize that a takeover or attempted takeover may be imminent, and the stock market price of the target company can be expected to rise dramatically. This is especially true if the acquirers disclose in their Williams Act filing a plan to acquire the target at a stated figure. In such a case, the market price will tend to rise to within a few points of the stated figure (and sometimes above the stated figure, if the market anticipates that a better offer will be made).

While generalities can be dangerous, at this point many of the target's public shareholders will sell their stock in order to realize the substantial gain resulting from the market's newly-formed expectation that a takeover will occur. The buyers will tend to be "risk arbitrageurs". The risk arbitrageur's objective is generally to earn a profit of a few points per share based on the difference between the ultimate takeover price and the market price for the stock after it is known that a takeover attempt is imminent. A primary risk that the risk arbitrageur takes is that no takeover will occur and that the market price for the stock involved will then revert to its previously depressed level. If that occurs, as it does from time-to-time, the risk arbitrageur usually may lose a substantial sum of money.

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[25] Furthermore, by the use of pre-existing shell corporations, the acquirers may be able to turn what would otherwise have been short-term capital gain into long-term capital gain. The technique involves using a shell corporation that has been held long-term by the acquirers. The shell corporation buys the target stock. If the target stock is to be sold before it has been held long-term, the acquirers simply sell the stock of the shell corporation instead. Given the provision in the Deficit Reduction Act of 1984 reducing from more than one year to more than 6 months the holding period requirement for long-term capital gain treatment, such a technique may be less necessary than it was prior to the Act.

What is significant about the risk arbitrageur's activity? The risk arbitrageur has become a stockholder primarily to earn a modest, short-term percentage profit on his investment. He is not an historic shareholder and may evaluate a proposed takeover offer differently than an historic shareholder would. Perhaps more importantly, the risk arbitrageur has a substantial interest in seeing that a takeover is consummated, for he may suffer greatly if that does not happen and the stock price drops back to its pre-takeover attempt level. Thus, the target corporation at this point may be owned to a large extent by persons whose main interest is in seeing that a takeover occurs. This is why it is thought by many that once a takeover attempt has started with respect to a target, a takeover of the target will likely occur, if not by the persons who started it, then by somebody else.

Once it is evident that the original acquirers are planning or threatening a takeover attempt of the target, the target management, usually acting through the target's board of directors, can be expected to react. In some cases, management may support the attempt and the related offer. In other cases, management may generally support the attempt but seek a better price. In many instances, however, management is likely to oppose the attempt. It is primarily this last case that introduces the term "hostility" into the corporate takeover lexicon.

There is no single reason why management may be opposed to a particular takeover attempt although frequently it is claimed that the proposed offer is "inadequate". If they are opposed, a number of things may happen. For example, management may try to stop the attempt on legal (e.g., securities or antitrust) grounds. Management may take steps to make the target less attractive to the potential acquirers (e.g., by selling important corporate assets, adopting "poison-pill" tactics, or persuading shareholders to adopt other defensive amendments to the corporation's articles of incorporation).[26] Or the target corporation may buy back any target stock the acquirers may have already accumulated at a premium price ("greenmail") in exchange for an agreement on the part of the acquirers not to commence a new takeover attempt for a period of years (a "stand-still" agreement). Perhaps such a buy-back will be a part of a broader transaction (e.g., a recapitalization and redemption or a leveraged buy-out). Finally, the target may search for a "white knight", a person or group of persons acceptable to management which is willing to buy the company on terms management does not oppose. Sometimes, management itself will be the white knight and buy the company in a "going private" transaction. If a white knight is found, target shareholders will tend to be content. Public shareholders will profit, whether they sold to risk arbitrageurs or to the white knight. The risk arbitrageurs will profit to the extent of the few points a share. And the original acquirers will make a large profit because much of their target stock was bought at the historic bargain price.

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[26] Many companies that view themselves as possible takeover targets take steps to make themselves unattractive before any particular takeover attempt has been started or threatened so that no such attempt will be made.

Recent years have seen the advent of the so-called "2-tier" offer. Even white knights have been known to use the 2-tier offer. In the 2-tier offer, the white knight (or other buyer) will announce plans to acquire part of the target for one price or on one set of terms and the balance for another price or on another set of terms. The price or terms for the first part will be more generous to shareholders than the price or terms for the second part. For example, the buyer, expecting to use borrowed funds, may make a tender offer for 60 percent of the target's stock at $60 in cash per share and announce that it will thereafter buy the remaining 40 percent at $55 in cash per share (or $55 in long-term installment obligations). Frequently the second step is carried out, after the first step has been completed (and the buyer has obtained control of the target), by means of a "squeeze-out" or "cram down" merger between the target and the buyer (or an affiliate of the buyer). The significant advantage to the buyer of the squeeze-out merger is that upon its completion, the buyer will own 100 percent of the target by reason of the operation of most State merger laws. That is, there will be no target minority shareholders. As a corollary, all former target shareholders will end up having made an exchange. If the transaction is not part of a tax-free reorganization,[27] those shareholders would end up having a taxable event, regardless of whether their participation was voluntary or involuntary.

The 2-tier offer provides significant advantages to a buyer. First, by offering a better price to those target shareholders who sell first, it is generally thought that persons who might not otherwise have sold their stock to the buyer will wish to do so, fearing that if they do not, they will end up having to sell in connection with the less favorable second step, the squeeze out merger. Second, it is obviously to a buyer's advantage to pay $60 per share for 60 percent and $55 per share for 40 percent, rather than $60 per share for 100 percent. And third, the 2-tier offer may permit the buyers to more easily finance the acquisition. For example, a buyer (for tax or for other reasons) may be able to get better financing terms from selling shareholders in an installment obligation squeeze-out merger than from a bank, insurance company, or other lender.

The above discussion obviously is not limited to a discussion of how tax considerations influence hostile takeover attempts. However, to the extent tax-law changes may be appropriate, they should not be considered in a vacuum.

B. The Acquisition Transaction Simplified: The Federal Income Tax Perspective

This section describes the tax profiles of various potential acquired corporations and various potential acquiring corporations or groups. It then indicates particular acquisition transactions that would appear to be the most beneficial to the parties from a Federal income tax standpoint under present Code rules. Under the circumstances, hostility between the potential acquirer and management of the target may or may not be present.

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[27] An acquisition cannot be a tax-free reorganization unless an acquiring corporation issues at least some of its (or a parent's) stock in the transaction. Most recent acquisitions of publicly-held companies have not been done as tax-free reorganizations. There are many reasons for this. One is that corporations are reluctant to issue common stock when the market price for that stock is low: issuing stock at such a time substantially dilutes the interests of the acquiring corporation's own shareholders. Another reason may be that, in the current takeover surge, stock of an acquiring corporation (rather than cash) is not psychologically satisfactory to the selling shareholders. A third reason is that many recent acquisitions have been "going private" transactions. Finally, section 338 elections are not available with respect to tax-free reorganizations.

The objective of this part is to inform the reader who is not an expert in the intricacies of subchapter C of the Code of (1) some of the tax benefits available in an acquisitions context, and (2) techniques authorized by the Code to obtain those benefits. Therefore, the cases described (which are not all-inclusive) are simplified cases, designed more to present general principles than to identify actual transactions. Part four contains a more technical exposition of many of the tax rules involved.

It is not intended to suggest that factors other than tax factors play no role in determining whether an acquisition is undertaken and, if so, in what form. Business, antitrust, regulatory, financial reporting, and other legal and personal concerns, among other considerations, are frequently as important, if not much more important, than tax matters. On the other hand, it is clear that tax considerations are very relevant in many acquisitions. Furthermore, if they are not the primary reason for an acquisition, they frequently provide some "gravy" or affect the price at which it is carried out.

One additional preliminary comment: section 269 of the Code deals with certain acquisitions the principal purpose of which is the evasion or avoidance of Federal income tax. Where 269 applies, the general effect is to prohibit the evasion or avoidance aimed at. In what follows, it is assumed in every case, without inference, that section 269 would not be applicable.

Case (1): Redemptions (share repurchases) with borrowed funds

Corporation M is a widely-held public company with little outstanding debt. It pays and has paid substantial taxes but still throws off significant cash flow. It may or may not pay large dividends to its shareholders.

From a tax standpoint, M should seriously consider borrowing a large sum of money and using the proceeds to redeem M stock held by some of its shareholders. There would be 2 significant tax advantages to such a strategy that would not be available under a "business-as-usual" approach.

First, the transaction generally could be structured so that any gain of the redeemed shareholders attributable to the distribution would be capital gain. In contrast, periodic distributions made by M to its shareholders would generally be fully taxed to them at ordinary income rates as dividends.

Second, M could deduct the interest it pays or accrues on the borrowed funds. This would enable M to reduce its taxable income, perhaps to an amount approximating zero (or even generate current tax losses which it could carry back to obtain tax refunds). If so, its Federal income tax liability would go down, and its cash flow could increase significantly. That increased cash flow might be sufficient to enable M to cover most of its debt service obligations with respect to the borrowed funds and retire much of the debt over a period of years (although M might also have to sell some of its assets to raise cash to assist it to pay off the loan). In substance, non-redeemed (i.e., continuing) shareholders would have acquired the stock of the redeemed shareholders substantially with pre-tax income. In contrast, had M not borrowed money to do the redemption, but used its own funds, the redemption would have been financed by M with after-tax income.

Thus, assume that M has 10 shares outstanding valued on the New York Stock Exchange at $100 each for a total of $1,000. The corporation has no debt, and its taxable income is $200. At a 46 percent tax rate, it pays taxes of $92.00, leaving it with a cash flow of $108.00. This is $10.80, or 10.8 percent, per share. It may or may not use all or part of that $108.00 to pay dividends to its shareholders.

Suppose M borrows $500 at 14 percent interest and uses the proceeds to redeem one-half (5) of its shares. After this transaction, it will have taxable income of $200 less $70 (interest expense), or $130. At a 46 percent tax rate, it will pay $59.80 in taxes, leaving it with a cash flow (before paying back any principal on the loan) of $70.20. That is $16.20 more than the pre-redemption 10.8 percent times the 5 shares still outstanding ($70.20 less $54.00). By servicing part of its capital with tax deductible amounts, the corporation will have increased its per share cash flow and, therefore, its per share value.

Case (2): Leveraged buy-out

If M does not proceed as suggested in Case (1) or a similar fashion, others may be willing to provide "assistance". Thus, a group of wealthy individuals, including some M management, may want to buy M in a "leveraged buy-out". They are prepared to contribute 20 percent of the purchase price as equity and have made arrangements to borrow the remaining 80 percent. The buying group will use Corporation MM, a newly-created company, as the acquiring vehicle. MM will buy all the stock of M in a taxable transaction (perhaps in part through a squeeze-out merger). Immediately after the acquisition, M will merge into MM. The lenders in the transaction will lend the 80 percent to MM on terms reflecting the degree of leverage and the loan security involved. (The market-place may characterize the debt as "junk" bonds.) The lenders in the transaction will lend the 80 percent to MM. Immediately after MM's merger into M, the loan will be secured by mortgages on and pledges of M's former assets now held by MM. Because of the interest deductions generated by the borrowing, MM, after the merger, may have little, if any, taxable income (and may have loss carrybacks). As a result, MM may be able to service its debt obligations out of a cash flow not reduced (or reduced less) by taxes. The buyers hope and expect that the loan (principal and interest) can be mostly paid off after several years out of that cash flow of MM. If so, M would have been acquired largely with its own pre-tax income.

Case (3): Change in shareholder investment without current tax; step up at death

Corporation A's assets have a value approximating their tax basis. A, an operating service company, has no significant net operating loss carryovers or other tax attributes. A has a single shareholder, individual X. X, age 75, has a very low basis in his A stock. Corporation B wants to acquire A.

From a tax standpoint, the sensible deal would be for B to buy A's assets for cash (perhaps raised through borrowing) or for B and A to combine in a tax-free reorganization (with X receiving B stock in exchange for his A stock). If B bought A's assets for cash and X kept A alive as a personal holding company, A would pay minimal tax and X would pay none. Through this personal holding company, X could then make portfolio stock investments and receive (after A paid taxes on its investment income) close to a market-rate return on an amount equal to the value of A. Thus, X would have significantly changed the nature of his holding, from an operating service company to a portfolio investment company, without being currently taxed on the gain in his stock. (Furthermore, after X's death, his heirs would inherit his A stock and take a fair market value basis in it under section 1014. As a result, the appreciation in value of the A stock in X's hand might go untaxed forever.)

If B and A did a tax-free reorganization, with X receiving B stock, neither A nor X would be taxed. (Again, upon X's death, his heirs would take a fair market value basis in his B stock, and no tax would ever have been imposed on the appreciation in X's stock.)

Alternatively, X may be able to sell his A stock to an employee stock ownership plan established by A and "roll over" the proceeds tax-free by investing them in securities of other operating corporations, thereby changing the nature of his holding from an operating service company to a portfolio of diversified securities, by putting in place a financing technique (the ESOP) permitting the acquisition of his stock for the employees of A. The basis of X in his A stock would be carried over to his new investments. See Case (14).

If, instead, B bought the A assets and A was then liquidated, or if B bought the stock of A from X, X could use the liquidation or sales proceeds to invest in portfolio stocks. In either such case, however, X would be taxed on the appreciation in the value of his A stock, leaving him with a smaller capital investment.

Case (4): Step up in basis with no corporate tax; tax-exempt shareholders

Corporation C's assets have a very low basis relative to their value. However, they have no depreciation or other recapture potential. C has no significant net operating loss carryovers or other tax attributes. C's sole shareholder, individual Y, has a basis in his C stock approximating its value. Corporation D wants to acquire C.

From a tax standpoint, a sensible deal would be for D to buy C's assets for cash (perhaps raised through borrowing). If D buys C's assets, C should liquidate under section 337. Alternatively, D could buy all Y's stock in C and make a section 338 election. (If D makes a section 338 election, the transaction would generally be treated by C as a sale of assets followed by a prompt liquidation under section 337.) In either case, Y would have only nominal tax liability, and C, under section 337, would have no tax liability at all with respect to the appreciation in value of its assets. Furthermore, D would take a "stepped-up" tax basis in C's old assets equal to their cost (and thus, for example, generally could begin depreciating them immediately under ACRS to the extent they were depreciable property). As a result, the appreciation in the value of C's assets would never be taxed to any corporation. In contrast, if there were no acquisition of C, C generally in the normal course of its business would pay tax on the appreciation in the value of its assets, and any distributions it made to Y generally would be taxed to Y as dividend income.[28]

If the parties did a tax-free reorganization, neither C nor Y would have any immediate tax liability, but D would inherit C's low asset basis and depreciation methods.

Case (5): Deferral of shareholder gain with installment sale

The facts are the same as in Case (4) except that individual Y has a low basis in his C stock. If a tax-free reorganization is done, nobody will pay any current taxes, but D will not get to step up the basis of C's assets. But if a cash transaction under section 337 or 338 is done, Y will have a large current tax liability. An alternative would be to have D issue its non-readily tradable term installment obligations, bearing a market rate of interest, for the C assets or stock (followed by a section 338 election). Under that approach, D would get an immediately usable basis in C's, assets in an amount equal to their cost (as well as annual interest deductions), and C would have no significant tax liability. Furthermore, Y, under section 453, could generally defer paying taxes on the appreciation in the value of his C stock until D made principal payments on the installment obligations. Meanwhile, Y would be getting from D market-rate interest on the entire principal amount of the obligations (i.e., the sales price). If the consideration to Y had been cash, Y could have invested at market rates only that amount less the amount of tax currently due on his gain. In effect, using section 453 would permit Y to obtain an interest-free loan from the Federal government.

Case (6): Avoiding recapture

Corporation E is a widely-held public corporation. Its assets have a tax basis which is low relative to their value. However, most of that difference would be treated as depreciation recapture (or similar items) were E to sell its assets for their value. Neither E nor Corporation F has any significant net operating loss carryovers. F wants to acquire E.

It would not make tax sense for F to acquire E's assets in a taxable transaction or for F to acquire E's stock in a taxable transaction and make a section 338 election. In either case, F would get a step up in basis for E's assets. However, E would have immediate ordinary (recapture) income in an amount approximating that stepup. The tax cost of that ordinary income would exceed the present value of the basis step up for the E assets. Therefore, F should consider buying the stock of E and not making a section 338 election (in which case the basis of E's assets would not change and E would have no taxable income, but the E shareholders would be taxed) or doing a tax-free reorganization with E. If such a reorganization were done, again the basis of E's assets would not change, but E's shareholders would generally have a tax-free transaction.

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[28] Suppose, instead, that C's sole shareholder in Case (4) is a tax-exempt organization or a foreign person who is not a U.S. taxpayer. (Much publicly-held corporate stock in this country is held by tax-exempt organizations.) Suppose further that shareholder has a low basis in its C stock. Under these facts, C could sell its assets and liquidate under section 337, or D could buy the C stock for cash and make a section 338 election. In either event, generally neither C nor its shareholder would have any U.S. tax to pay under present law.

Case (7): Use of acquirer's NOLs

The facts are the same as in Case (6) except that F (but not E) has large net operating loss carryovers that it does not expect to be able to use in the normal course of its own operations. In this case, F should consider buying all the E stock in a taxable transaction and not making a section 338 election, in which case there would be no change in the basis of E's assets. Thereafter, F could sell some or all of the E assets for their value. Assuming F and E are filing consolidated returns, F's net operating loss carryover could be used to offset the gain to E on the sale of its assets. E could then reinvest the sales proceeds in new assets, which may or may not be similar in function to the assets sold. As a result, the new E assets would get a new basis, and no corporate tax would ever be paid on the recapture income inherent in the old E assets (although E's shareholders would be taxed). Alternatively, the parties could do a tax-free reorganization to the same end. In that case, E's shareholders would generally have a tax-free transaction.

Case (8): Target built-in loss

Corporation G is a widely-held public company. Its assets have a tax basis which is very high relative to their value (i.e., there is "built-in loss"), and it is not currently paying taxes. Corporation H, which is very profitable and pays substantial taxes, wants to acquire G.

H should not buy G's assets in a taxable transaction or buy the G stock in a taxable transaction and make a section 338 election. In either case, the basis of G's assets would be reduced ("stepped down") to their cost, and the benefits of G's built-in loss would disappear. Rather, H should consider buying G's stock in a taxable transaction and not making a section 338 election. In that case, while G's shareholders would be taxed, there would be no change in the tax basis of G's assets. Assuming G and H file a consolidated return after the acquisition, H, subject to several limitations, would be able to make use of G's built-in loss through depreciation deductions or sales of G assets. Thus, H could receive tax benefits based on an amount substantially in excess of what it paid for the G stock. This differs from general Code principles, under which tax benefits are usually based on cost to the taxpayer.

Alternatively, G and H could combine in a tax-free reorganization, with similar results. Furthermore, in that case, G's shareholders would generally not be taxed currently.

Case (9): Acquisition by a loss corporation

Corporation I is a very profitable corporation which pays significant taxes. Its assets have a tax basis approximating their fair market value. Corporation J has net operating loss carryovers. J wants to acquire I.

J has substantial tax-planning flexibility. It could acquire the I assets in a taxable transaction, it could acquire the I stock in a taxable transaction, or it could acquire I in a tax-free reorganization. In any such case, J would be putting itself into a position where it could deduct from future taxable income generated by I (or the former I assets) its own net operating loss carryovers from periods preceding the acquisition.

Case (10): Acquisition of NOLs

The facts are the same as in Case (9) except that I has significant net operating loss carryovers, and J pays substantial taxes. J should not buy I's assets in a taxable transaction or buy the I stock in a taxable transaction and make a section 338 election. If it did, I's net operating loss carryovers would not be available to it. Under almost any other acquisition form, J could acquire I, including its net operating loss carryovers. Subject to some limitations, J could then use I's pre-acquisition carryovers to offset its own (or I's) post-acquisition taxable income.

Case (11): Liquidating sales to different buyers

Corporation Q is a widely-held holding company. Its assets consist of all the stock of each of 10 operating companies, none of which is held as inventory. Q's aggregate basis in that stock is well below the aggregate value. An investor group wants to acquire Q for cash. It creates newly-formed corporation P, and P buys all the stock of Q. P does not make a section 338 election. After the purchase, P causes Q to make liquidating sales of the stock of each of its 10 subsidiaries, for cash, to 10 unrelated corporate buyers, each buyer buying one subsidiary. Q and P both then liquidate, the investor group ending up with the cash received by Q on the separate sales of its subsidiaries.

Under this transaction, generally P and Q would not be taxed, despite the appreciation in value of Q's holdings. The investor group would be taxed on any gain, probably at long-term capital gains rates (as would shareholders of Q who sold their stock to P). Each of the 10 different buyers would be able to make an independent judgment as to the wisdom of a section 338 election with respect to the stock of the subsidiary it just acquired. Some probably would make an election, and some would not.

These results could also have been achieved by Q alone, without P's (or the investor group's) participation.

Case (12): Overfunded pension plan

Corporation K is a widely-held public corporation. K maintains a defined benefit pension plan established for the exclusive benefit of its employees. The plan is a qualified plan under section 401, and the related trust qualifies for tax exemption. The trust is currently overfunded by approximately $100 million on a termination basis. That is, if the trust were currently to be terminated, its assets would exceed the present value of the benefits accrued under the plan by K employees up to the date of plan termination. Corporation L wants to acquire K.

Under almost any form of acquisition, L, subject to some limitations, could cause K to terminate its pension plan. The termination would enable L, directly or indirectly, to obtain the $100 million. It could be used to assist L in paying for the acquisition, for general corporate purposes, or for any other purpose. While the $100 million would be included in the gross income of K (or L) upon termination of the plan, any net operating losses and loss carryovers of L (or K, depending on the acquisition form) could be used to offset that income.

If K did not desire to be acquired, it would be well-advised to terminate the plan itself and to make good business use of the proceeds. K would be a less attractive takeover candidate in that event, for it would not have $100 million in readily-available cash as an inducement to a potential acquirer. Futhermore, K may even be able to establish a new pension plan.

Case (13): Leveraged acquisition

Another potential buyer of M in Case (1) may be another widely-held public company. That company could borrow the money to buy M stock, perhaps with installment obligations, from the M shareholders. The buying company would deduct its interest expenses, thus reducing its (and M's) Federal income tax liability (perhaps even enabling it to obtain a refund of prior taxes paid) and increasing cash flow. Again, that increased cash flow would make it easier for the borrowed money to be repaid. Again, M would have been acquired largely with untaxed income.

It is possible that the interest deductions on the borrowing would not be large enough to fully offset M's post-acquisition taxable income. However, in a case like Case (13), the buying company could make a section 338 election after acquiring the M stock (as could MM in Case (2)). If such an election made tax sense, making it would have the effect of reducing post-acquisition taxable income. Thus, for example, if M assets needed to be sold to raise cash to service the debt, a section 338 election could insulate M from having to pay taxes on the sale. Or the buying company in Case (13) may have net operating loss carryovers or current operating losses of its own. If so, it could use those to bring post-acquisition taxable income down even further. Finally, M's buyer might cause M to transfer its assets to a partnership composed of M and an unrelated corporation having large loss carryovers. The partnership rules may permit the parties to structure the partnership in such a way that substantially all income from the former M assets would be offset by the loss company's carryovers. If so, little tax would be paid, thus making it easier for M's buyer to make debt service payments.

Case (14): ESOPs

All the stock of Corporation N is owned by individual Z. Z's basis in the N stock is substantially below its fair market value. Z wants to sell most of his N stock. N could set up an ESOP for its employees. N could then borrow an amount equal to, say, 80 percent of the fair market value of its stock from a bank or an insurance company. The loan may be secured by mortgages and the pledges of N's assets. N could then reloan the loan proceeds to the ESOP on substantially the same terms on which it borrowed them. The ESOP could then use the loan proceeds to buy 80 percent of the N stock from Z. The ESOP would pay off the loan with contributions made to it by N in subsequent years. Z would use the sales proceeds to invest in a portfolio of securities of public companies traded over the New York Stock Exchange.

Under section 1042, this transaction would produce no immediate tax consequences to Z. Recognition of his gain would be deferred. As a result, Z may be willing to sell his N stock for a price lower than would otherwise be the case. The bank or insurance company lender to N, under section 133, would be able to exclude from its gross income 50 percent of the interest income on its loan to N, so it should be willing to lend at a favorable rate of interest. And N generally could deduct that part of its contributions to the ESOP used to pay off principal on its loan to the ESOP. As a result, the dollars used to buy the N stock from Z would not be currently taxable to anyone.

Case (15): Hostile takeovers

Corporation O is a widely-held public company the stock of which is traded on the New York Stock Exchange. The stock is currently selling at $40 per share. A group of investors determines that, based on the net value of its underlying assets, O is really worth $80 per share. The investor group, through a newly-created or an existing corporation, begins buying O stock, on the exchange, at $40 to $45 per share, largely with borrowed funds. After acquiring 5 percent of O's outstanding stock, the investor group's corporation makes a tender offer, at $60 per share, for the balance of O's stock. Most of the cash to be used in the tender offer would be borrowed by the tendering corporation. The investor group has financing commitments from prospective lenders under which the corporation can borrow, on an unsecured and subordinated basis, the funds it may need to finance the tender offer at an interest rate of several points over prime. The high rate on the debt ("junk" bonds) reflects the credit evaluation made by the prospective lenders.

The tender offer may be successful. If so, a section 338 election could be made, and interest payments would be deducted by the new corporation. This could reduce post-acquisition tax liability and increase cash flow available to service the debt.

If O does not wish to be acquired by the investor group, a number of other things may happen. Among them are the following 3 possibilities. First, O may try to dissuade the investor group from proceeding with the tender offer by offering to buy back the 5 percent of its stock held by the group. O may offer $60 per share. If this "greenmail" offer is accepted, O might claim (based on very dubious authority) a tax deduction for all or a portion of the $60 per share, and the investor group's corporation would probably claim that its profit qualifies as long-term capital gain (even though it will generally deduct against ordinary income interest expense incurred to carry the stock). Second, O may search around for a "white knight". If O is successful, it may find a white knight who will buy all of O for $65 per share. Again, the investor group's corporation will likely claim capital gain treatment. (What the white knight does in the way of acquisition planning (e.g., using borrowed money or making a section 338 election) will depend on the tax profiles of O and itself.) Third, O may set up an ESOP to buy, with borrowed funds, some of its stock. (This may assist O in fending off the acquisition attempt because the ESOP might be viewed as less inclined to accept the tender offer than would O's public shareholders.) Generally, 50 percent of interest payments made by the ESOP with respect to those borrowed funds would be excludible from the lender's gross income. Furthermore, O would in effect end up with deductions for contributions it makes to the ESOP to enable it to amortize the loan.

IV. PRESENT LAW RULES

Part two of this pamphlet looked, from a tax policy perspective, at how present Code rules may influence whether a corporate acquisition is done and, if so, in what form. Part three discussed hostile takeovers and illustrated the application of general Code rules in the context of simplified acquisition cases. This part discusses, on a more detailed and technical level, many of the operative rules, without regard to whether the acquisition involved is hostile or grew out of a hostile offer.

A. Forms of Acquisition

An acquiring corporation can structure the acquisition of another corporation as a taxable purchase or as a tax-free reorganization. In either case, the transaction can take the form of an acquisition of assets or an acquisition of stock. As indicated in part three, the form of an acquisition is influenced by factors such as the nature of the consideration to be used (e.g., cash, or stock or debt of a party to the acquisition), the opportunity to step up the basis of the acquired corporation's assets, and the question of whether it is advantageous to preserve the acquired corporation's tax history (e.g., net operating loss carryovers, credit carryovers, and built-in losses).

What follows is a technical description of many of the Federal income tax rules that govern corporate acquisitions involving domestic corporations, including the treatment of shareholders of acquired corporations.

1. Taxable acquisitions

If the consideration used by an acquiring corporation is cash or other property (rather than stock of the acquiring corporation or a corporation in control of the acquiring corporation), the acquisition will be a taxable purchase of the acquired corporation's assets or stock. A putative reorganization that fails to qualify for tax-free treatment, where the consideration consists of stock or a combination of stock and cash (or other property), is also treated as a taxable purchase.

a. Asset acquisitions

A taxable sale of assets by a corporation normally results in the recognition of gain or loss to the corporation unless the corporation liquidates within a prescribed period and satisfies certain other requirements (discussed below).[29] The acquirer takes a cost basis for the acquired assets (generally equal, in the aggregate, to the amount of cash and the fair market value of any property used as consideration). No gain or loss is recognized by the shareholders of the selling corporation unless the corporation distributes all or part of the sale proceeds.

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[29] This case usually involves nothing more than the sale by a corporaton of only some of its assets in the ordinary course of business and its continuation in business. It is not a corporate acquisition at all.

Treatment of selling corporation

The selling corporation in a nonliquidating sale recognizes gain or loss equal to the difference between the amount realized (i.e., the cash and the value of any property received) and its basis with respect to each asset. Recognized gain or loss is ordinary income or loss, long-term capital gain or loss, or short-term capital gain or loss, depending on the nature and holding period of the transferred property. For example, if the selling corporation recognizes a net gain from depreciable assets that were used in its trade or business and held for the period required (generally more than 6 months), then the gain may be taxed as long-term capital gain pursuant to section 1231. Ordinary income and net short-term capital gain are taxed to corporations at a maximum rate of 46 percent. A corporation's net capital gain (the excess of net long-term gain over net short-term loss) is subject to an alternative tax of 28 percent if the tax computed using that rate is lower than the corporation's tax would be using the regular rates.

Recaptures.—Part of all of the selling corporation's gain may be characterized as ordinary income under a "recapture" provision. The recapture rules, and similar rules, are generally designed to prevent the conversion of ordinary income into capital gain (or unrecognized gain) by requiring gain on disposition of certain property to be taxed as ordinary income to the extent of deductions previously taken against ordinary income with respect to the property.

Under the depreciation recapture rules of section 1245, gain is taxed as ordinary income to the extent of all prior depreciation deductions taken with respect to personal property. Under section 1250, if part or all of the cost of nonresidential real property qualifying as recovery property was recovered under the accelerated depreciation method, recognized gain is treated as ordinary income to the extent of all prior recovery deductions taken. On the other hand, if the property was not depreciated under an accelerated method, none of the gain is recapture income. Section 1252 provides a recapture rule for transfers of farm land. Under this provision, a portion of the post-1969 amounts deducted for soil and water conservation or clearing land is subject to recapture.

If mining property is included in the assets disposed of, recognized gain is treated as ordinary income to the extent of post-1965 mining exploration expenditures previously deducted under section 617 (reduced by the amount of foregone depletion deductions). Similarly, if oil and gas properties are sold, section 1254 provides for the recapture of amounts deducted for post-1975 intangible drilling and development costs (less the amount of foregone cost depletion deductions). Section 1254 also applies, with respect to post-1977 development costs, to transfers of geothermal property. Depletion deductions are not subject to recapture.

In addition to the recapture of previously-claimed deductions, section 47 provides for the recapture of investment tax credits. If eligible property is disposed of prior to the end of the period that was taken into account in computing the credit claimed by the taxpayer, then the credit is recomputed. For example, in the case of recovery property that qualified for the regular 10 percent credit, on an early disposition, the credit is recomputed by allowing a 2-percent credit for each full year the property was held. The difference between the credit originally claimed and the recomputed credit is generally treated as a dollar-for-dollar increase in the selling corporation's tax liability for the year of sale. This recapture occurs whether the property is sold at a gain or at a loss.

Sales by liquidating corporations.—In the acquisition context, a corporation selling assets can, under section 337, avoid the recognition of gain (other than recapture and similar income) with respect to sales that occur within a 12-month period beginning on the date the corporation adopts a plan of complete liquidation by distributing all of its assets (less assets retained to meet claims) during such 12-month period. Nor will it recognize loss with respect to any such sales. Section 337 generally does not provide nonrecognition treatment on a sale of assets by a corporate subsidiary, however, unless all corporations in the chain above the subsidary are also liquidated. Nor does section 337 generally apply if the corporation is a "collapsible corporation" (discussed below).

Ordinarily, the selling corporation recognizes neither gain nor loss on liquidating sales of assets (or on the distribution of its assets in a complete liquidation).[30] However, gain is recognized (as ordinary income) to the extent of recapture income under the rules described above. In addition, if the selling corporation maintained inventories using the LIFO (last-in-first-out) method for Federal income tax purposes, the corporation will recognize ordinary income in an amount equal to the excess of the value of the inventory using the FIFO (first-in-first-out) method over the value using the LIFO method. Furthermore, the corporation will recognize income on piecemeal liquidating sales of its inventory. Finally, investment tax credits are also subject to recapture, as described above.

In addition to the statutory recapture provisions, the selling corporation may be viewed as recognizing income on a liquidation (or a liquidating sale) under the "tax benefit" doctrine or assignment of income principle. For example, the U.S. Supreme Court has applied the tax benefit doctrine to tax a liquidating corporation on the distribution of previously-expensed items to its shareholders. *United States* v. *Bliss Dairy, Inc.*, 460 U.S. 370 (1983), *rev'g*, 645

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[30] Prior to the enactment of the Deficit Reduction Act of 1984, generally no gain (other than recapture income) was recognized to a corporation that made a nonliquidating distribution of appreciated property with respect to its stock. There were several cases under prior law where the failure to tax currently the ordinary, nonliquidating distribution of appreciated property to a shareholder resulted in tax avoidance. For example, in several-widely publicized transactions, publicly-held oil companies transferred royalty interests carved out of long-held working interests in oil and gas leases to a trust and distributed units of interests in the trust to their shareholders without paying any corporate-level tax (except on recapture). Under the 1984 Act, nonliquidating distributions of appreciated property to corporate shareholders are taxable to the distributing corporation. Ordinary distributions to noncorporate shareholders are also taxed to the distributing corporation with limited exceptions. However, except for recapture, liquidating distributions are not taxable events to distributing corporations. In addition, under the 1984 Act, the basis of a corporate shareholder's stock may be reduced by the nontaxed portion of an extraordinary dividend (sec. 1059).

F.2d 19 (9th Cir. 1981). Tax benefit recapture could also apply to require the recognition of income with respect to other items such as bad debt reserves.

Similar rules apply in the case of certain taxable stock purchases if a section 338 election is made (discussed below). In fact, most taxable acquisitions are cast as stock purchases. By using a stock purchase, the acquirer can more easily and deliberately assess the wisdom of making a section 338 election. In the liquidating sale case, there is no decision to be made after the sale: the transaction will be treated as if such an election had been made.

Consequences to acquiring corporation

The acquiring corporation in a taxable purchase of assets takes a cost basis in the acquired assets (sec. 1012). Thus, for example, if appreciated assets are purchased, the basis of the assets are stepped up to reflect the acquiring corporation's cost, regardless of whether the selling corporation is taxed on the appreciation in the value of those assets. Similarly, if the assets purchased have depreciated in value, the basis is stepped down in the hands of the acquiring corporation. The acquiring corporation will not succeed to the tax history (e.g., carryovers) of the selling corporation.

The value of any step up depends, in part, on the nature of the acquired corporation's assets. For example, because land (or goodwill) is not depreciable, the benefit of stepping up its basis is generally realized only on a subsequent disposition of the property (by reducing taxable gain). On the other hand if the basis of a depreciable asset is stepped up, the acquiring corporation will be entitled to larger depreciation deductions than would have been allowed to the selling corporation. Likewise, a step up in the basis of inventory will eventually be reflected in the acquiring corporation's cost of goods sold (and thereby reduce its taxable income).

Shareholders of selling corporation

In general, the sale of a corporation's assets does not generate a tax at the shareholder level. However, if the selling corporation distributes the sale proceeds in a complete liquidation, each of the corporation's shareholders recognizes gain or loss (generally capital in nature) equal to the difference between the value of the liquidating distributions and the basis of the stock (sec. 331).

Possible application of collapsible corporation rules.—The "collapsible corporation" rules are designed to prevent the conversion of ordinary income into capital gain by engaging in an activity through a corporation and, before a substantial amount of the resulting income to be realized is realized at the corporate level, disposing of the stock in the corporation at a price that reflects the unrealized earnings (sec. 341). A shareholder who receives a liquidating distribution from, or sells stock in, a collapsible corporation is generally taxed at ordinary income rates if the gain recognized would otherwise have been treated as long-term capital gain. Individuals are taxed on long-term capital gains at a maximum rate of 20 percent. The maximum rate of tax on ordinary income and net short-term capital gain of individuals is 50 percent.

b. Stock acquisitions

A taxable purchase of a corporation's stock from its shareholders results in the recognition of gain or loss by such shareholders. Gain on stock sales is generally taxed at capital gain rates unless the collapsible corporation rules (discussed above) apply or the stock was not held as a capital asset. Absent an election to treat the stock purchase as an asset acquisition under section 338 (described below), no gain or loss is recognized by the acquired corporation, and the basis of its assets and its tax history are unaffected. However, the acquiring corporation takes a cost basis in the purchased stock.

In the case of widely-held acquired corporations, a common practice is for the acquiring corporation to tender for all of the acquired corporation's outstanding stock and, after purchasing a significant portion of that stock for cash (or installment debt), to cause a newly-formed subsidiary to merge into the acquired corporated under applicable state law in a squeeze-out merger. In the merger, the acquired corporation's remaining shareholders will also receive cash (or installment debt) for their shares. A reverse merger of this type is generally treated as a taxable purchase of the acquired corporation's stock (but see the discussion below regarding tax-free reverse subsidiary mergers).

Treatment of the acquired corporation

The acquisition of part or all of a corporation's stock is generally a nonrecognition event for the corporation. Thus, the basis of the acquired corporation's assets is unchanged. Similarly, there is no effect on other tax attributes such as accumulated earnings and profits. Assuming that the transaction does not run afoul of section 269 (which authorizes the disallowance of certain benefits and deductions if the principal purpose of an acquisition was tax avoidance), net operating loss carryovers and unused tax credits, etc. will remain fully available to the acquired corporation if it continues to carry on a trade or business that was conducted before the acquisition (secs. 382 and 383).[31] Furthermore, any built-in loss of the acquired corporation will survive. Thus, the acquired corporation generally retains the ability to reduce taxes that would otherwise have been paid with respect to future income.

Stock acquisitions treated as asset acquisitions.—A corporation that makes a "qualified stock purchase" (the acquisition of at least 80 percent of another corporation's voting stock and at least 80 percent of all other classes, excluding nonvoting preferred, within a specified time period) can elect to treat the stock purchase as a direct purchase of the assets of the acquired corporation (sec. 338). If a section 338 election is made, the acquired corporation is generally treated as if it had adopted a plan of complete liquidation and sold all of its assets at the close of the acquisition date under section 337. The acquired corporation is deemed to have sold its assets for a price equal to their fair market values. Nonrecognition treatment is generally provided to the acquired corporation to the same extent that gain or loss would go unrecognized if there were an actual sale and liquidation subject to section 337 (see the discussion above). Thus, for example, as in the case of a liquidating sale, the recapture rules are fully applicable.

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[31] Section 382 imposes special limitations on the use of NOL carryovers following an acquisition. Section 383 provides similar limitations on attributes other than NOL carryovers. The rules are sometimes criticized as too generous to taxpayers and as technically flawed. 1976 amendments to the rules are generally scheduled to go into effect for taxable years beginning after 1985, but they are under reconsideration.

As of the day following the acquisition date, the acquired corporation is treated as a new corporation that purchased all of the assets held by the acquired corporation. Thus, the basis of each of the acquired corporation's assets is generally stepped up (or down) to its cost to the acquiring corporation (measured by the price paid for the stock and adjusted for liabilities of the acquired corporation and other relevant items).[32] In addition, the acquired corporation's tax attributes are unavailable to the acquiring corporation.

Consequences to acquiring corporation

The acquiring corporation takes a cost basis for the purchased stock. Although the acquiring corporation does not directly succeed to the tax history of the acquired corporation, it can benefit indirectly from attributes such as NOL carryovers if the acquired corporation joins the acquiring company in the filing of a consolidated return for Federal income tax purposes and if no section 338 election is made or deemed made. If the acquired corporation is subsequently liquidated into the acquiring corporation, the acquired corporation's tax history will carry over to the acquiring corporation (unless the principal purpose of the transaction was tax avoidance).

Consolidated returns.—Generally, if, after the acquisition, the acquired corporation is included in an affiliated group of corporations that files a consolidated return, the other corporations in the affiliated group can deduct their post-acquisition losses (and sometimes their pre-acquisition losses) against the acquired corporation's post-acquisition income. Conversely, losses recognized by the acquired corporation after the acquisition (other than certain built-in losses, described below) will offset post-acquisition income generated by other members of the affiliated group.

Suppose, for example, that Corporation A anticipates earning substantial taxable income and paying substantial taxes in the years ahead as an independent company. Suppose also that Corporation B anticipates earning economic income but incurring tax losses in the years ahead as an independent company. The tax law provides a strong incentive for one corporation to acquire the other so that B's tax losses will offset A's taxable income with the result that A and B together will pay no taxes. The consolidated return rules are an available vehicle. Thus, those rules may encourage acquisitions to occur which would not otherwise have occurred. For example, some have argued that the ability of a property and casualty insurance company to file consolidated returns with non-insurance companies and, to a lesser extent, the ability of such a company to file consolidated returns with life insurance companies have prompted the acquisition in recent years of many independent property and casualty companies by non-insurance companies or by life insurance companies and caused significant disruption in the property and casualty insurance industry.[33]

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[32] Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), a corporation could in some instances acquire the stock of another corporation in a taxable purchase and then effect asset step ups only with respect to selected assets, i.e., where a step up was most advantageous. This selectivity was achieved by causing a partial liquidation of the acquired corporation. TEFRA modified the treatment of a partial liquidation so that only certain noncorporate shareholders of the distributing corporation would be treated as receiving amounts distributed in partial liquidation as in exchange for stock. One of the principal effects of this change was to deny an acquiring corporation a step up in the basis of properties distributed to it by a newly-acquired corporation in partial liquidation. TEFRA also adopted other rules which attempted to prohibit "selective" step ups, e.g., the consistency rules of section 338.

In addition to the special limitations on NOL carryovers in section 382, under the "separate return limitations year" (SRLY) rules provided by regulation (see Treas. regs. sec. 1.1502-21(c)), NOL carryovers of a newly-acquired member of an affiliated group cannot offset income of other members of the group. (The "consolidated return change of ownership", or "CRCO", rule provides similar treatment with respect to the NOL carryovers of an affiliated group acquired by certain persons.) Because an acquired corporation is permitted to use NOL carryovers to offset its "own" income, however the SRLY rules can frequently be avoided by, among other things, diverting income-producing activities (or contributing income-producing assets) from elsewhere in the group to a newly-acquired corporation (but see sec. 269).

Applicable Treasury regulations (see Treas. regs. sec. 1.1502-15) also prohibit the use of an acquired corporation's built-in losses to reduce the post-acquisition taxable income of other members of an affiliated group. Under the regulations, built-in losses are subject to the SRLY rules. In general, built-in losses are defined as deductions or losses that economically accrued prior to the acquisition but are recognized for tax purposes after the acquisition, including depreciation deductions attributable to a built-in loss (Treas. reg. sec. 1.1502-15(2)). For example, if the acquired corporation owns a building with a basis of $100 and a value of $50 as of the acquisition date, the $50 potential loss may be treated as a built-in deduction. The built-in loss limitations do not apply unless, among other things, the aggregate adjusted basis of certain assets of the acquired corporation exceeds the value of those assets by more than 15 percent. Further, assuming that section 269 is inapplicable, the application of the SRLY rules to built-in losses can be avoided by causing the acquired corporation to generate additional taxable income (as described above).

Subsidiary liquidations.—Absent a section 338 election, and assuming no significant tax avoidance motive, a corporation can liquidate a newly-acquired subsidiary corporation and directly succeed to the acquired corporation's tax attributes (secs. 332 and 381). No gain or loss is recognized, and no recapture occurs, to the liquidating subsidiary corporation or to the distributee parent corporation (secs. 336 and 332), and the distributee corporation takes a carryover basis in the assets received in the liquidation (sec. 334). The acquiring corporation's basis in the purchased stock will "disappear".

Section 381 enumerates tax attributes that carry over to a parent corporation as the result of the liquidation of a subsidiary. A major item is earnings and profits or a deficit in earnings and profits. In general, a deficit in an acquired corporation's earnings and profits cannot be applied against the acquiring corporation's accumulated earnings and profits; however, the deficit can reduce the acquiring corporation's post-acquisition earnings and profits. Thus, even if the acquiring corporation at the time of the acquisition has accumulated earnings and profits, after such earnings and current earnings are paid out as dividends the acquired corporation's deficit could result in the future payment of tax-free dividends (treated as a return of capital to the acquiring corporation's shareholders). Of course, the acquired corporation's deficit in earnings and profits may be unimportant if the acquiring corporation's accumulated earnings and profits are so great that there is little likelihood of reducing them to zero.

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[33] See "Skinning the Cat", *Forbes Magazine* (April 22, 1985), p. 121.

Examples

(1) The opportunity to step up basis

The parties to an acquisition may or may not wish to step up the basis of the acquired company's assets. As indicated, there is a tax cost (or "toll charge") to such a step up—recapture income, etc., to the acquired company. As the examples below show, there will be many cases in which a step-up election is not advantageous. Since those step-up and toll charge results are automatic in the case of a liquidating sale of assets by an acquired company, most taxable acquisitions are structured as purchases of stock. In a purchase of stock, step up and recapture will occur only if the buyer so elects. Further, the law gives the buyer some period of time to determine whether the election should be made.

The decision to elect to step up the basis of all assets and pay recapture taxes or, alternatively, to have basis carry over and have no recapture tax, generally is determined with reference to several tax and financial attributes of the acquiring corporation and the acquired corporation. The following example illustrates the net tax benefits and costs of a step-up election under a limited and simple set of assumptions.

Assume that the acquired corporation acquired all its assets on January 1, 1981, and that all its stock is sold on January 1, 1984. Five types of assets are involved in the transaction:

(1) Section 1245 equipment, in the 5-year ACRS class;

(2) Section 1250 structures, depreciated under the straight-line method;

(3) Section 1254 intangible drilling costs (three-tenths of which would have been recovered through cost depletion);

(4) Lease acquisition costs (three-tenths of which have been recovered through cost depletion); and

(5) LIFO inventories.

Both parties are assumed to be fully taxable at a 46-percent marginal rate. The acquired corporation has no liabilities. (See Table 6.)

Table 6.—Asset Analysis and Recapture Tax

Assets	Original cost—Jan. 1, 1981	Jan. 1, 1984—			
		Tax basis	Purchase price	Recapture income	Recapture tax
Section 1245 equipment	$10,000	$4,200	$8,000	$3,800	$1,748
Section 1250 structures	10,000	8,000	12,000		
Section 1254 IDCs	1,000	0	1,000	700	322
Lease acquisition	1,000	700	1,000		
FIFO inventory	1,750	1,750	1,750		
LIFO inventory (excess over FIFO)		75	75	75	35
ITC					400
Total	$23,750	$14,650	$23,825	$4,575	$2,505

The original cost of the assets was $23,750. After 3 years, their purchase price (and fair market value) is $23,825, while their tax basis has been reduced to $14,650. If the basis is stepped up, recapture tax of $2,505 must be paid. The net tax benefit of a step-up transaction (determined without regard to present value considerations), after payment of recapture tax, is $1,681 (assuming that no tax benefit is to be realized with respect to the inventory and, for ease in understanding, disregarding the effect on purchase price of the recapture tax liability). Because recapture tax generally is payable in the first year and the tax savings will occur over the remaining tax lives of the assets, present values must be considered. With the future cost of funds and yield on investments unknown, the parties should considered the transaction under a range of reasonable discount rates. At a 10-percent discount rate there would be a net loss of $143. At higher discount rates, the loss from a step-up transaction would be greater. No step-up election is indicated. (See Table 7.)

Table 7.—Net Benefit of Step Up

Discount rate	Zero	10%	12%	15%	20%
Net tax savings	$1,681	–$143	–$334	–$562	–$831

On the other hand, if the facts were changed so that the fair market value (and purchase price) of the assets created by the IDCs and the lease was increased to $4,000 each, a step-up election would be indicated under any reasonable discount rate. (See Table 8.)

Table 8.—Net Benefit of Step Up with Higher FMV

Discount rate	Zero	10%	12%	15%	20%
Net tax savings................	$4,442	$1,553	$1,225	$823	$326

The parties may forego a step-up election even if the amount of projected tax savings indicates that a step up may be beneficial. There are a number of reasons for this. First, the acquiring corporation may have borrowed substantial sums of money to make the acquisition. It may have difficulty raising additional funds to pay the tax liability attributable to recapture. Second, the Internal Revenue Service, on audit, may challenge the claimed results, particularly the taxpayer's claim as to the value (or cost) of separate assets or their character as depreciable property. In few areas of the tax law is there more opportunity for controvesy, especially if the acquired company was a large publicly-held company. As a result, there may be significant uncertainly as to the final costs and benefits. Third, no benefits will be available unless the acquiring corporation or its affiliated group has taxable income in the future against which to apply increased deductions resulting from the step up. An acquiring corporation that assumes without question that it will be able to use those benefits as they become available will be taking some risk.

(2) Preserving built-in losses

If an acquired corporation's assets have an aggregate basis that is materially greater than their value, an acquiring corporation will wish to structure the acquisition so that the basis will carry over (rather than being stepped down to reflect the acquiring corporation's cost). Maintaining the high basis of low-value assets may permit the acquiring corporation to make use of the built-in losses against post-acquisition taxable income. The following example illustrates the manner in which an acquiring corporation could benefit from a built-in loss.

Assume that the acquired corporation holds three types of property:

(1) Land with a value and basis of $1 million;

(2) Equipment that is 5-year recovery property with a value of $2.5 million and an adjusted basis of $5 million, which equipment is depreciated using a straight-line method over an optional recovery period of 12 years (resulting in an annual deduction of about $833,333); and

(3) Section 1250 structures with a value and basis of $4 million.

The above example assumes that the remaining recovery period for the equipment is 6 years.

Assuming that the acquired corporation has no liabilities, the acquiring corporation presumably will pay at least $7.5 million for the stock of the acquired corporation. The aggregate $10 million basis would survive. Section 269 could apply to disallow depreciation deductions attributable to the $2.5 million built-in loss with respect to the equipment. See Treas. reg. sec. 1.269-3(c)(1) (to the effect that a corporation which acquires property with a built-in loss and utilizes the property to create tax-reducing deductions may be deemed to have had tax avoidance as its principal purpose). Nevertheless, the acquiring corporation may be able to utilize the built-in loss if it is able to establish that there are business reasons to rebut the presumption of a tax-avoidance motive. Because of the possible application of Section 269, and the resulting uncertainty regarding the acquiring corporation's ability to use the built-in loss, the existence of the loss may not have a significant effect on the purchase price.[34]

If the acquired corporation could be expected to generate $750,000 of taxable income (before equipment depreciation) in each of the next 6 years, and the built-in depreciation deductions are allowed in full, the deductions would yield a tax saving of at least $345,000 each year (46 percent of $750,000), resulting in an after-tax rate of return at least equal to the pre-tax rate of return of 10 percent.

If the acquiring corporation had simply purchased the assets directly, under the statutory table provided in section 168(b), the maximum depreciation deduction that would have been available in the year of acquisition would have been $375,000 (or 15 percent of the $2.5 million cost), rather than $833,333. Assuming the same 10-percent (pre-tax) rate of return, the acquiring corporation would pay tax on $375,000 ($750,000 of income less the $375,000 depreciation deduction). Assuming a 46 percent tax rate, the after-tax return on a direct purchase would be only 7.7 percent ($750,000 less the tax of $172,500) for that year and would not reach 10 percent for any year.

Because the acquired corporation's post-acquisition income in the stock purchase example was insufficient to make full use of the built-in loss, the acquiring corporation may take steps to increase that income. For example, if the acquiring corporation is engaged in the same line of business as the acquired corporation, the acquiring corporation could divert business to its new subsidiary. Alternatively, the acquiring corporation could make a capital contribution of a profitable division to the acquired corporation. These steps could increase the after-tax rate of return above 10 percent—by sheltering income that would otherwise have been taxed to the acquiring corporation.

If the equipment had a value of $3.5 million, so that the aggregate value of the acquired corporations assets was equal to 85 percent of the aggregate basis, the acquired corporation could join in the filing of a consolidated return without running afoul of the SRLY rules. Thus, any depreciation deductions in excess of the acquired corporation's needs could be used to offset income generated by other members of the affiliated group.

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[34] On the other hand, if the buyer is not worried about section 269, it should be willing to pay more than $7.5 million for the stock—$7.5 million for the assets and something more for the tax benefits that the built-in loss will provide.

2. Tax-free reorganizations

In general, to qualify an acquisitive transaction for tax-free treatment, the shareholders of the acquired corporation must retain "continuity of interest" in the combined enterprise. Thus, among other things, at least a principal part of the consideration used by the acquiring corporation must consist of stock.

The definition of the term "reorganization" is found in section 368(a). This provision lists 4 basic types of acquisitive reorganizations involving unrelated corporations: statutory mergers (or type "A" reorganizations); stock-for-stock exchanges (referred to as "B" reorganizations); transfers of substantially all of a corporation's assets for stock (type "C" reorganizations); and bankruptcy reorganizations (or type "G" reorganizations, which may be acquisitive or divisive in character). In addition to the statutory prescriptions, other rules apply including, for example, the "continuity of business enterprise" rule. See Treas. reg. sec. 1.368-1(d). A qualified reorganization generally results in the nonrecognition of gain or loss by the acquired corporation and its shareholders except to the extent that nonqualifying consideration (or "boot") is used. Further, the acquired corporation's basis for its assets and its tax history carry over.

a. Asset reorganizations

Type A and Type C reorganizations are essentially asset acquisitions in which the acquired corporation goes out of existence. Compared to an A reorganization, the type of consideration that can be used in a C reorganization is limited. On the other hand, the acquiring corporation can pick and choose which liabilities of the target corporation it will assume in a C reorganization. In a type A reorganization, the acquiring corporation assumes all of the acquired corporation's liabilities by operation of law.

Statutory mergers

The type A reorganization is a statutory merger or consolidation under state or Federal law (sec. 368(a)(1)(A)). The statute does not prescribe the type of consideration that must be used in a statutory merger; however, the "continuity of interest" doctrine requires that the consideration include a significant equity interest in the acquiring corporation.[35] In the transaction, the acquired corporation normally merges into the acquiring corporation, and the merged corporation's shareholders exchange their stock for consideration provided by the acquiring corporation. There are no express limits on the ability of the acquired corporation to dispose of unwanted assets before the merger.

"Forward" subsidiary merger.—The definition of an A reorganization also includes a "forward" subsidiary merger, in which the acquired corporation merges into a subsidiary of the corporation that provides the stock used as consideration in the merger (sec. 368(a)(2)(D)). To qualify a forward subsidiary merger as a type A re-

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[35] Compare *John A. Nelson* v. *Helvering*, 296 U.S. 374 (1935) (where 38 percent of the consideration consisted of nonvoting preferred stock and 62 percent of cash, the requirement was satisfied), with *Pinellas Ice & Cold Storage Co.* v. *Commissioner*, 287 U.S. 462 (1933) (short-term notes did not provide sufficient continuity).

organization, substantially all of the merged corporation's assets must be acquired. Thus, pre-merger dispositions by the acquired corporation are limited. Under Internal Revenue Service ruling guidelines, generally the "substantially all test" is satisfied if the transferred assets constitute 90 percent of the value of the net assets, and 70 percent of the value of the gross assets, held by the acquired corporation immediately before the transfer. Rev. Proc. 77-37, 1977-2 C.B. 568.

"Reverse" subsidiary mergers.—In a "reverse" subsidiary merger, a subsidiary of the acquiring corporation merges into the acquired corporation, with the acquired corporation surviving the merger (sec. 368(a)(2)(E)). Although this transaction is similar to a type B reorganization (described below), it is included in the definition of a statutory merger. The surviving corporation must hold substantially all of the properties of both corporations after the transaction. Also, in the merger, shareholders must transfer stock representing "control" of the acquired corporation in exchange for voting stock of the acquiring corporation. For this purpose, control is defined as ownership of at least 80 percent of the voting stock, and at least 80 percent of every other class of stock, of the acquired company (sec. 368(c)).

Type C reorganizations

A type C reorganization is an acquisition of substantially all of a corporation's assets "solely" in exchange for voting stock of the acquiring corporation (or of a corporation in control of the acquiring corporation) (sec. 368(a)(1)(C)). In determining whether qualified consideration is used, the acquiring corporation's assumption of a liability is disregarded. Under the "boot relaxation rule" of section 368(a)(2)(B), up to 20 percent of the consideration can consist of property other than stock of a party to the reorganization, although the 20-percent limitation is reduced by the amount of liabilities assumed by the acquiring corporation.

The type C reorganization provisions are intended to apply to transactions that are functionally equivalent to statutory mergers. In a statutory merger, the acquired corporation is liquidated by operation of law. Thus, as a result of the Deficit Reduction Act of 1984, the statute requires the complete liquidation of a corporation whose assets are acquired in a C reorganization unless this requirement is waived by regulations. Even if the liquidation requirement is waived, however, the transaction is treated as if a complete liquidation had occurred.

b. Stock reorganizations

A type B reorganization is an acquisition of stock of the acquired corporation solely in exchange for voting stock of the acquiring corporation (or a corporation in control of the acquiring corporation) (sec. 368(a)(1)(B)), if immediately after the acquisition the acquiring corporation has control of the target corporation. Unlike the reverse subsidiary merger, where the acquiring corporation must obtain control in the transaction, a B reorganization can be accomplished by a "creeping acquisition" of the acquired corporation's stock.

c. Bankruptcy reorganizations

A type G reorganization is defined as a transfer of part or all of a corporation's assests to another corporation in a title 11 or similar proceeding if stock or securities of the transferee are distributed in a transaction that qualifies under section 354, 355, or 356 (sec. 368(a)(1)(G)). To facilitate insolvency reorganizations, the continuity of interest doctrine (described above) is generally applied by reference to the continuing interests of creditors of the debtor (acquired) corporation.

d. Treatment of parties to a reorganization

Acquired corporation

A corporation does not recognize gain or loss on the transfer of its property for stock or securities of a corporation that is a party to the reorganization (sec. 361(a)). If the acquired corporation also receives nonqualifying consideration, then gain (but not loss) is recognized unless the boot is distributed pursuant to the plan of reorganization (sec. 361(b)). In general, the acquiring corporation's assumption of the acquired corporation's liabilities is not treated as boot.

Shareholders and security holders

Generally, no gain or loss is recognized by shareholders or security holders who exchange stock or securities solely for stock or securities in a corporation that is a party to the reorganization (sec. 354(a)).[36] if the exchange also involves the receipt of nonqualifying consideration, gain (but not loss) is recognized up to the amount of the boot. Further, part or all of the gain may be taxed as a dividend (at ordinary income rates) if the exchange has the effect of a dividend. In general, a shareholder or security holder is treated as receiving boot if the principal amount of securities received exceeds the principal amount of securities surrendered, if securities are received and no securities are surrendered, or if property other than stock of a corporate party to the reorganization is received.

If the exchanging shareholder or security holder receives only qualified consideration, the exchanging taxpayer takes a basis in the qualified consideration that is equal to the basis of the stock or securities surrendered in the exchange (sec. 358(a)). Thus, recognition of gain is deferred until a subsequent disposition of the stock or securities received. (The appreciation in the stock (or securities) can escape taxation entirely if the shareholder holds the qualified consideration until death. In that case, the basis in the hands of the taxpayer's estate will be stepped up to its fair market value.) Security holders are taxed on the receipt of qualified consideration attributable to accrued interest on securities surrendered (sec. 354(a)(2)).

Boot dividends.—The determination of whether the receipt of boot has the effect of a dividend is generally made by reference to the principles of section 302 (which provides rules for distinguishing ordinary dividend distributions from capital gain redemptions). Under section 302, a distribution is generally treated as a dividend if the distribution does not effect a significant change in the shareholder's interest in the distributing corporation.[37] In the case of an ordinary distribution, the amount is taxed as a dividend to the extent of available (current or accumulated) earnings and profits. Under section 356, however, a boot dividend is taxed at ordinary income rates only to the extent of the lesser of the shareholder's (1) gain, or (2) ratable share of accumulated earnings and profits. Where a taxpayer receives boot, the basis of the boot is generally equal to its fair market value, and the taxpayer's basis in qualified consideration is decreased by the value of the boot and increased by the amount of any recognized gain (including as a dividend).

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[36] The Deficit Reduction Act of 1984 added Code section 1042. It provides an alternative to a tax-free reorganization in which a selling shareholder can sell his stock to an ESOP on a tax-deferred basis.

Acquiring corporation

Section 1032 provides nonrecognition treatment to an acquiring corporation that issues its stock to acquire property, even if the issuance is not part of a tax-free reorganization. Similar treatment is provided if a subsidiary corporation transfers its parent's stock in a qualifying reorganization. See Rev. Rul. 57-278, 1957-1 C.B. 124. See also Treas. prop. regs. sec. 1.1032-2. The acquiring corporation generally takes a carryover basis for assets or stock acquired in a reorganization, increased by any gain recognized to the transferor on the transfer (sec. 362(b)). In addition, the acquiring corporation in an asset reorganization generally "steps into the shoes of" the acquired corporation with respect to earnings and profits, NOL carryovers, and other tax attributes (sec. 381). The special limitations on the use of NOL carryovers do not come into play unless the equity interest received or retained by a loss corporation's shareholders is less than 20 percent of the acquiring corporation's outstanding stock (sec. 382(b)). However, section 269 could apply to disallow NOL deductions if the principal purpose of the acquisition was tax avoidance. If the acquired corporation remains in existence (as in a type B reorganization), it can join in the filing of a consolidated return (as described above in the description of taxable acquisitions), although the SRLY rules (including those rules insofar as they relate to built-in losses) would apply.

Examples

(1) Utilization of acquired corporation's NOL carryovers

The acquiring corporation may structure an acquisition as a tax-free reorganization to preserve the acquired corporation's tax history without maintaining the acquired corporation as a separate entity. The following example illustrates the application of the rules that permit an acquiring corporation to utilize the NOL carryovers of an acquired corporation.

Assume that the acquiring corporation projects that it will have taxable income of $1 million for each of the next 5 years. Also assume that the acquired corporation has NOL carryovers of $20 million and that none of the carryovers will expire before the end of 5 years. The acquired corporation also has assets used in its trade or business, but these assets are not expected to generate taxable income.

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[37] Compare *Wright* v. *United States*, 482 F.2d 600 (8th Cir. 1973) (dividend equivalency was measured by shareholders' continuing interests in the surviving corporation after a consolidation of 2 related corporations), with *Shimberg* v. *United States*, 577 F.2d 283 (5th Cir. 1978) (where, following a merger, the court tested dividend equivalency by assuming a hypothetical redemption by the acquired corporation before the merger).

If the acquired corporation is merged into the acquiring corporation under section 368(a)(1)(A), the $20 million NOL carryover will survive and be inherited by the acquirer (sec. 381). Assuming that the acquired corporation's shareholders receive only 5 percent of the acquiring corporation's outstanding stock, the present-law special limitations would disallow 75 percent (or $15 million) of the NOL carryover (sec. 382(b)). Even so, the $5 million carryover that remains available would be sufficient to cover the acquiring corporation's earnings over the next 5 years. The stock used as consideration could be nonvoting preferred stock, giving the acquired corporation's shareholders only a limited interest in the acquiring corporation.

Assuming that the acquiring corporation is taxable at a 46-percent marginal rate (and, so, would have paid about $460,000 in tax for each of the 5 years in question), the use of the acquired corporation's NOL carryover would yield tax savings of $2.3 million. Of course, the present value of the tax savings would be somewhat less than $2.3 million, depending on the discount rate used.

The special limitations on the use of NOL carryovers following a reorganization (rather than a taxable purchase) do not require that the acquiring corporation continue the acquired corporation's business, although the continuity of business enterprise doctrine may limit the acquiring corporation's ability to simply dispose of the acquired corporation's unwanted assets. In addition, section 269 may be implicated if the acquiring corporation discontinues the acquired corporation's business. See Treas. regs. sec. 1.269-6 (example (1)). Alternatively, the acquiring corporation might choose to continue the acquired corporation's uneconomic business, to head off assertions that the acquisition was principally tax-motivated. In any event, because of the possible application of section 269, the value of the NOL carryover may be discounted for purposes of setting the value of the consideration paid to the acquired corporation's shareholders.

(2) Acquisitions by corporations with NOL carryovers

Instead of selling a corporation with large NOL carryovers, the loss corporation's shareholders may decide to cause it to acquire another profitable corporation in a tax-free reorganization to make use of its own carryovers. The special limitations on the use of NOL carryovers generally would not apply if the loss corporation's shareholders retained at least 20 percent of the combined enterprise.

B. Financing Aspects of Acquisitions

1. In general

Although a corporation could be acquired solely for cash that has been accumulated, after taxes, by the acquirer, virtually all mergers and acquisitions involve some—often a substantial—degree of financing. Financing may take the form of either equity (common or preferred stock) or debt. The tax consequences to the parties to a corporate merger or acquisition and their shareholders vary depending on whether debt or equity financing is used. As is discussed, the tax law contains a strong bias in favor of debt financing. Many recent acquisitions have been accomplished using a high degree of leverage.

a. Equity financing

As discussed above, if the acquirer is a corporation, it may issue its own stock in exchange for target stock or target assets. Alternatively, the acquiring corporation might obtain funds by selling its own stock in the market and then using the proceeds to acquire the stock or assets of the target.

If the merger or acquisition is accomplished through the issuance of stock of the acquiring corporation, the transaction will be tax-free to that corporation (sec. 1032) and may be tax-free to the target corporation's shareholders and the target corporation if certain requirements are met. If the transaction involves an exchange of stock or securities by the shareholders of the target corporation, and the exchange fails to qualify under the reorganization provisions of the Code, each shareholder of the target corporation will recognize gain to the extent the value of the stock or securities received exceeds the shareholder's basis in the stock or securities surrendered. Generally, the entire amount of any gain will be recognized in the year of the sale.[38]

Distributions by the acquiring corporation with respect to stock issued to finance an acquisition, whether to the former shareholders of the target corporation or to others, generally will not be deductible by the acquiring corporation. Moreover, these distributions will generate ordinary dividend income to individual shareholders to the extent of the issuing corporation's earnings and profits. Thus, the income reflected by these distributions generally will be subject to double taxation. Finally, in certain circumstances, payments received by the shareholders in redemption of their stock may be treated as dividend income rather than as proceeds from the sale or exchange of the stock.

One common nontax consequence of using equity rather than debt financing is that interests of the pre-acquisition stockholders of the acquiring corporation may be diluted by the issuance of additional shares of stock.

b. Debt financing

An acquirer may purchase the target corporation's stock or assets using funds borrowed from domestic or foreign banks or other financial institutions or from individual or corporate investors (e.g., pension funds or insurance companies). A corporate acquirer could also borrow from the target corporation or its shareholders by issuing its own debt obligations to the target or its shareholders in exchange for assets or stock. The stock or assets purchased with the proceeds of the debt may be pledged as security for the loan.

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[38] Similar consequences would generally follow from a nonqualifying exchange of assets by the target corporation for stock of the acquiring corporation. In certain circumstances, however, section 337 might permit nonrecognition of gain at the corporate level.

Subject to certain limitations,[39] interest paid or accrued on a loan is deductible by the borrower for tax purposes (sec. 163). Although payments of interest are in theory ordinary income to the lender, all repayments of loan principal are tax-free.[40] (Of course, repayments of principal will result in some taxation of the lender if the loan was part of an installment sale under section 453.)

Financing an acquisition using corporate debt does not directly affect the equity of the shareholders of an acquiring corporation. However, as discussed in parts two and three, the use of debt financing can reduce significantly the after-tax cost of an acquisition. This follows from the simple rule that the issuer of debt can deduct the amount it pays for the use of the borrowed funds (interest), while the issuer of stock cannot deduct the amount it pays to those providing the capital for the use of that capital (dividends).[41]

2. Specific provisions affecting debt-financed acquisitions

a. Cost recovery allowances and installment reporting

The Accelerated Cost Recovery System (ACRS) generally permits the cost of depreciable assets acquired after 1980 to be recovered on a much more accelerated basis than assets acquired in previous years. The deductions allowed under ACRS in early periods of use of an asset are often very large when compared to the actual economic deterioration of the asset.

In some cases, the tax benefits resulting from ACRS may provide a target corporation with significant liquid assets and an attractive cash flow, thus increasing its attractiveness as a takeover candidate. In addition, similar benefits may provide a large portion of the debt service costs incurred by an acquirer in financing an acquisition (or internally-generated cash used in the acquisition). For example, the large deductions available under ACRS in the early years following acquisition may shelter income of the acquirer (in the case of an asset purchase) or of the target corporation (in the case of a stock purchase followed by a section 338 election), thus reducing tax liability. These tax savings are the equivalent of cash payments to a taxpayer.

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[39] In limited circumstances, section 279 denies a deduction for interest on corporate acquisition indebtedness. The limitation applies to interest in excess of $5 million per year incurred by a corporation with respect to debt obligations issued to provide consideration for the acquisition of the stock, or two-thirds of the assets of, another corporation, if each of the following conditions exists: (1) the debt is substantially subordinated; (2) the debt carries an equity participation (for example, includes warrants to purchase stock of the issuer or is convertible into stock of the issuer); and (3) the issuer is thinly capitalized (i.e., has an excessive debt-to-equity ratio) or projected annual earnings do not exceed 3 times annual interest costs.

[40] By contrast, as noted above, payments in redemption of corporate stock may be treated as dividends (ordinary income) rather than as proceeds from a sale (which would permit the recipient a tax-free recovery of its basis in the stock).

[41] Some corporations which have sufficient earnings to pay dividends under applicable state corporate law do not have taxable income for Federal income tax purposes. These corporations would receive no current tax benefit from interest deductions. Instead of issuing debt obligations, therefore, they may issue preferred stock with substantial debt-like characteristics or common stock. Because of the 85 percent dividends received deduction, the preferred stock would likely be acquired by taxpaying corporations. The result is that the tax benefits of the financing (i.e., deductions for financing costs) are in part passed on to the buyer of the stock, which can better use them. However, as a result of the 1984 Act, if a corporation borrows the funds used to purchase dividend-paying stock, the dividends received deduction may be reduced in certain situations (sec. 246A). The amount of the reduction is determined by the degree of leverage involved.

The basis of the acquired assets for depreciation purposes is the cost of the assets or, where a section 338 election is made, the cost (with adjustments) of the target stock. Under long-established principles of tax law, the cost of an asset includes not only cash paid but the principal amount of any purchase-money debt.[42] This debt may be represented by an installment note, in which case the aggregate tax benefits available to the parties may be magnified. Under section 453, gain on an installment sale may be deferred and recognized by the seller as payments of principal are received if, among other things, the installment obligation received is not payable on demand or readily tradable. Thus, while the seller recognizes gain on a deferred basis (which gain generally is treated as capital gain), the purchaser immediately receives a cost basis which includes the full principal amount of the note. If a target's assets have been purchased (or its stock purchased and a section 338 election made), some or all of that cost may be allocable to depreciable assets.

Because the sales proceeds realized by a seller in an installment sale qualifying under section 453 are not reduced in the year of sale by taxes, the seller can realize a higher after-tax return on the proceeds than if the installment method were not used or available. Furthermore, under present law, the seller may be able to raise cash by borrowing against the installment obligation without triggering any tax consequences. If so, the primary reason for permitting section 453 to apply—that the seller has no cash with which to pay current taxes—disappears.

Example

Assume that on January 1, 1986, P Corporation purchases all of the stock of T Corporation from T's sole shareholder, A. As consideration for the stock, P gives A its non-readily tradable term installment note with a face amount and a fair market value of $1 million. The note bears interest at an annual rate of 13 percent,[43] payable annually in arrears. The principal amount is payable in a lump sum on December 31, 1995. A's adjusted basis in his stock is $200,000, as is T's basis in its assets.

If A does not elect out of the installment method, under section 453 he will recognize no gain in the year of sale. He will report $130,000 of ordinary interest income in each of the 10 years the note is outstanding and will recognize $800,000 of capital gain income in the year the note matures (1995). The tax at that time will be $160,000.

By contrast, if A had received $1 million in cash or marketable securities in lieu of the installment note (and therefore would have been ineligible for installment reporting), he would have recognized $800,000 of capital gain income in 1986, would have paid $160,000 in taxes in that year, and would have had only $840,000 in proceeds left to reinvest. Assuming he could have invested the proceeds at the same pre-tax rate of return he earned on P's installment note (13 percent), his annual income from the reinvestment would be only $109,200 (leaving as little as $54,600 after taxes), compared to $130,000 (as little as $65,000 after taxes) in the installment method case.

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[42] The principal amount may be adjusted downward if the debt instruments bears inadequate interest (see secs. 483 and 1274).

[43] Assume that this rate is adequate for purposes of section 1274.

Even if A uses the installment method and recognizes no gain on the sale until 1995, if P makes a section 338 election T will be entitled to an immediate step up in basis in its assets. T's new basis will be based on $1 million, the purchase price of the T stock. To the extent T's assets are depreciable, T could immediately begin to take depreciation deductions using a $1 million basis rather than a $200,000 basis. Furthermore, P will be deducting $130,000 each year as interest expense. These deductions could be used by P to offset T's income or P's income.

b. Provisions relating to qualified pension plans

Overfunded pension plans

If a pension, profit-sharing, or stock bonus plan qualifies under the tax laws ("qualified pension plan"), a trust holding the plan's assets generally is exempt from Federal income tax. Furthermore, contributions to a qualified pension plan by an employer are deductible, within specified limits, in the year for which the contributions are made. The participants in the plan, however, are not taxed on plan benefits until the benefits are distributed.

Under a defined benefit pension plan,[44] minimum funding rules apply that require an employer to make contributions to the plan so that an employee's retirement benefit will be fully funded upon his retirement. Under certain of the permissible funding methods, an employer's funding costs are levelled over an employee's working years even though the costs of benefits earned normally increase as the employee approaches retirement age. Thus, at any time, the plan may have assets that exceed the present value of the liabilities to employees for previously accrued benefits.

In addition, in recent years, high interest rates have contributed to substantial increases in the value of the assets held in many trusts under qualified pension plans. Although these increases in value must be amortized over 15 years in calculating the employer's minimum funding costs, one effect may be that a plan's assets may be substantially greater than its liabilities prior to the time the amortization period has expired.

If a qualified pension plan is terminated, the rights of employees to benefits accrued up to the date of the plan termination must be nonforfeitable. Although a qualifed pension plan must be established for the exclusive benefit of employees, present law provides that an employer is entitled to recoup excess plan assets on plan termination to the extent the plan has assets remaining after all obligations to employees have been satisfied (i.e., to the extent that the plan is overfunded). If the excess assets represent amounts previously deducted by the employer or earnings on those amounts, the employer is required to include the recouped amounts in gross income for the year in which the amounts are received. Other deductions or credits (including loss carryovers) that the employer is entitled to claim may be used to offset the tax on this income.

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[44] A defined benefit pension plan is a plan under which an employee accrues ("earns") a specified retirement benefit that is not related to the amount of assets held by the plan or any account balance maintained for the employee.

An overfunded pension plan represents a pool of assets that may make a company a target for a takeover. Conversely, this pool of assets may be used by the company to ward off a hostile takeover. In recent years, some companies with significantly overfunded pension plans have been acquired by other companies. After the acquisition, the acquiring company terminated the overfunded pension plan and used the excess assets partially to finance the takeover.

It has been suggested that, as companies become more familiar with the existence of excess assets in their pension plans, the role of overfunded pension plans for an acquiring company will be diminished. On the other hand, it has been argued that an overfunded plan represents an attractive source of cash even if the value of the assets are included in the purchase price. Under the latter analysis, companies with overfunded pension plans will continue to be attractive takeover targets.

Another possibility is that a company will itself terminate an overfunded pension plan to assist its efforts to thwart a hostile takeover attempt. This can be accomplished in one of 2 ways. First, the company can invest the excess assets in plant equipment, thus making itself less attractive than if it held a large amount of liquid assets. Alternatively, the company can establish an employee stock ownership plan funded with the excess assets.

Employee stock ownership plans

An ESOP is a qualifed stock bonus plan or a combination stock bonus and money purchase pension plan which may be utilized as a technique of corporate finance. Under an ESOP, employer stock is acquired for the benefit of employees. ESOPs are accorded preferential tax treatment under the Code as an incentive for corporations to finance their capital requirements or their transfers of ownership in such a way that employees have an opportunity to gain an equity interest in their employer. Thus, ESOPs are exempt from tax under the rules generally applicable to qualified employee benefit plans, and, subject to statutory limitations, employer contributions to an ESOP are tax deductible.

An ESOP that borrows funds to purchase employer securities is referred to as a "leveraged" ESOP. An employer may deduct the full amount of any contribution to a leveraged ESOP that is used by the ESOP to pay interest on a loan to purchase employer securities and may deduct amounts used to repay loan principal in amounts up to 25 percent of payroll costs.

The Deficit Reduction Act of 1984 added additional tax incentives to the establishment and use of ESOPs, including the following:

(1) A taxpayer owning qualified securities in an employer corporation may defer recognition of gain on the sale of the securities to an ESOP that holds at least 30 percent of the employer's securities, to the extent the taxpayer reinvests the proceeds in securities of certain domestic corporations.

(2) A corporate employer may deduct dividends paid on employer stock held by an ESOP and allocated to participants' accounts if the dividends are paid currently to employees.

(3) A bank, insurance company, or corporation actively engaged in the business of lending money may exclude from its gross income 50 percent of the interest earned with respect to any loan the proceeds of which are used by an ESOP to purchase employer securities.

(4) Executors eligible under Code section 6166 to make deferred payments of estate taxes may be relieved of liability to the extent that qualified employer securities are acquired from a decedent by an ESOP, pass from a decedent to an ESOP, or are transferred to an ESOP by the decedent's executor if the ESOP is required to pay the liability.

A leveraged ESOP can be used by an employer as a technique of finance to obtain funds for working capital, plant expansion, or other purposes. Use of this financing technique can result in a lower cost of borrowing than would be available if conventional debt or equity financing were used. In a typical transaction, the employer enters into a contract with the ESOP to sell the ESOP a specified number of shares of its stock. The ESOP borrows the funds needed to purchase the shares from a bank or other lender and pays them over to the employer in exchange for the stock.[45] In subsequent years, the employer makes tax-deductible cash contributions to the ESOP in the amount necessary to amortize the loan principal and make interest payments thereon.[46]

A leveraged ESOP may be used not only to provide the company with working capital but also to finance an acquisition of the stock or assets of another corporation. In a typical case, a leveraged ESOP maintained by the acquiring corporation or its subsidiary borrows funds in an amount equal to the amount needed to acquire the target corporation. The proceeds of the loan are used to purchase employer securities from the employer. The employer (or the subsidiary) then uses the proceeds of the sale to purchase the stock or assets of the target company. Within statutory limits, the employer's contributions to the leveraged ESOP to enable it to amortize the loan will be deductible. In this manner, the corporation may reduce its after-tax cost of financing the acquisition.

One variation of this leveraged-ESOP financing technique is for the employer to purchase target stock, either directly or through a subsidiary, using funds borrowed from a financial institution or other lender. Once the acquisition has been completed, the newly-acquired subsidiary establishes a leveraged ESOP. The ESOP borrows money and purchases stock in the subsidiary from the subsidiary (or from the acquiring corporation). The acquiring corporation then uses the proceeds of this sale to pay off the original acquisition loan. The subsidiary makes annual, deductible contributions sufficient to amortize the ESOP loan and pay interest.[47]

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[45] The lender usually requires either that the employer guarantee the loan or that the stock purchased with the loan proceeds be pledged as collateral. Because of the 50-percent interest exclusion available to the lender, it may be able to lend to the ESOP at a lower rate than it lends to its regular customers not utilizing ESOP financing techniques (or other tax-favored financing techniques.)

[46] Alternatively, the employer may take out the loan itself and sell its stock to the ESOP in exchange for the ESOP's installment note. The employer will make (deductible) contributions to the ESOP in future years that will enable the ESOP to pay off the note. These payments will be used by the employer to repay its lender.

Recently, leveraged ESOPs have been used in some situations to thwart hostile corporate takeover attempts. By selling stock to an ESOP, a company may make it difficult for a hostile bidder to acquire control, since stock held by an ESOP might be expected to be voted to keep the company independent. Proceeds of the sale are generally available for any purpose. Moreover, a sale of stock to the ESOP will not necessarily dilute management's control of the company to the same degree as a sale to outside parties. The stock purchased by the corporation for its employees is held in a suspence account and released for allocations to employees' accounts as the acquisition loan is repaid. Prior to the time the acquisition loan is repaid and stock is allocated to employees' accounts, the shares may be voted by plan trustees on the employees' behalf in accordance with the fiduciary standards of the Employee Retirement Income Security Act of 1974. In some cases, the shares sold to the ESOP may have more limited voting rights than are granted to shareholders of public companies.

Leveraged ESOPs have also been used to accomplish leveraged buy-outs by persons desiring to take the company private.

Other issues relating to qualified pension plans

In addition to the potential use of qualified pension plans (including ESOPs) as financing tools in mergers and acquisitions, other issues are presented when companies, who maintain qualified pension plans, merge. These issues depend, in part, upon whether the successor company continues to maintain any of the qualified pension plans of the predecessor company. A full analysis of these issues is beyond the scope of this pamphlet.

c. Provisions relating to international taxation

Interest and dividends paid to foreign lenders and shareholders

In general, U.S. source dividends and (prior to the 1984 Act) interest paid to a nonresident alien individual or foreign corporation that are not "effectively connected" with the conduct of a U.S. trade or business of the individual or corporation are subject to tax at a flat rate of 30 percent (secs. 871 and 881). The payor is obligated to withhold the appropriate amount of tax (secs. 1441, 1442). Interest and dividends paid by a U.S. corporation on its debt obligations are generally treated as U.S. source income.

In many cases, the interest withholding tax imposed by sections 871 and 881 of the Code is reduced or eliminated by the provisions of an income tax treaty between the United States and the country in which the recipient resides. Furthermore, under the 1984 Act, interest paid to certain foreign persons with respect to certain portfolio debt investments is wholly exempt from U.S. tax. Accordingly, interest that is fully deductible by a U.S. corporate payor may be received wholly free of U.S. taxation by the foreign lender.

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[47] If the management and shareholders of the target company cooperate in the acquisition, it is possible that a portion of the proceeds of the sale of target stock by original target shareholders would qualify for tax-free rollover under section 1042. Thus, the acquiring corporation and the target shareholders could agree in advance that a portion (enough to qualify the ESOP as a 30-percent shareholder) of their shares would be purchased by a leveraged ESOP established by the target and the balance by the acquiring corporation. The proceeds of the sale to the ESOP might qualify for tax-free reinvestment under section 1042.

U.S. source dividends, although not deductible by the U.S. payor, may also be subject to a reduced withholding tax pursuant to a treaty between the United States and the shareholder's country of residence.

Sourcing of interest expense

A U.S. taxpayer may generally claim a credit against its U.S. tax for income taxes paid to a foreign government. In order to prevent foreign taxes from offsetting taxes on U.S. source income, however, the Code limits the credit to the amount of U.S. tax that would have been payable on the foreign income. The maximum foreign tax credit available to a taxpayer in a particular year is the amount of the foreign tax multiplied by a fraction the numerator of which is the taxpayer's foreign source taxable income and the denominator of which is its worldwide taxable income. Thus, a corporation increases its limiting fraction, and hence its usable foreign tax credit, to the extent it can treat income as foreign source income. The same result is achieved when an expense is treated as U.S. rather than foreign source.

A multinational corporation (one with significant foreign as well as domestic assets and earnings) seeking to acquire a domestic corporation using borrowed funds may not be able to increase the utility of the foreign tax credit by virtue of the borrowing. Treasury regulations require that a taxpayer's interest expense be allocated between U.S. and foreign source income based on the relative value of the taxpayer's assets. Thus, the multinational's foreign assets would normally attract a portion of the interest expense on the acquisition indebtedness.

The sourcing rules under present law, however, provide ample opportunity for manipulation by a corporation seeking to maximize its foreign tax credit utility. To avoid having the interest expense on acquisition indebtedness reduce its foreign source income, and hence the foreign tax credit limitation, the corporation may have the acquisition indebtedness incurred by a related corporation (e.g., a parent holding company) whose income is entirely derived from U.S. sources. In this manner, the interest expense would not affect the corporation's foreign tax credit, but, as a member of the parent's affiliated group, the corporation would nonetheless receive the benefits of the acquisition indirectly.

d. Provisions relating to partnerships

The tax law permits a partnership to flow through to its partners items of deduction and loss paid or incurred by the partnership. In some cases, general or limited partnerships have been used to acquire the stock (or assets) of a target corporation, using both funds borrowed by the partnership from institutional lenders and funds contributed as equity by the partners. Interest paid on the acquisition indebtedness is usually deductible by the partners, generally on a pro rata basis although special allocations may be possible.

In these situations, no dividends received deduction is available to a partnership or its individual partners with respect to dividends received from the target corporation. However, to the extent the partners are not corporations, dividends received will not trigger the extra 6.9 percent tax imposed on most intercorporate distributions. Furthermore, the partnership may end up owning and operating the business of the target corporation directly, including after a section 337 transaction. In such a case, tax benefits generated by the business will pass through directly to the partnership's partners, again, generally on a pro rata basis although special allocations may be possible.

The partnership provisions may also permit an acquired corporation to shelter taxable income with loss carryovers of an unrelated corporation, thus making it easier for any money borrowed in connection with the acquisition to be paid off with pre-tax dollars.

C. Golden Parachutes

Corporations are generally permitted a deduction for all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on a trade or business. Generally, reasonable compensation for salaries or other compensation for personal services actually rendered qualifies as ordinary and necessary expenses. In recent years, many corporations have entered into arrangements, commonly called "golden parachutes", to provide substantial payments to top executives and other key personnel of the corporation in connection with any acquisition that might occur.

Golden parachutes are designed in part to dissuade an interested buyer, by increasing the cost of the acquisition, from attempting to proceed with an acquisition. If the takeover does not occur, the target's executives and other key personnel would more likely retain their positions, so the golden parachute could effect the preservation of the jobs of such personnel. Where no takeover had yet commenced but the corporation viewed itself as an unwilling potential target, golden parachutes were often entered into to discourage potential buyers from becoming interested.

Sometimes, an acquiring corporation will enter into long-term employment contracts or similar arrangements with key personnel of the acquired corporation. These arrangements can remove the incentive for such personnel to examine a proposed takeover carefully.

The 1984 Act imposed significant tax burdens on the use of certain kinds of arrangements of a type described. Under the 1984 Tax Act, no deduction is allowed for "excess parachute payments". Further, if any such payment is made by the acquiring company, or a shareholder of the acquired for the acquiring company, it will not be treated as part of the acquiring company's purchase price for the acquired company, or as increasing the shareholder's basis in his stock in the acquired or acquiring company. Finally, a nondeductible 20-percent excise tax is imposed on the recipient of any excess parachute payment.

V. POSSIBLE CHANGES IN THE FEDERAL TAX RULES APPLICABLE IN HOSTILE TAKEOVERS

Many of the Federal tax rules operating in the context of a hostile takeover or a hostile takeover attempt are general Code rules, e.g., the deductibility of interest. Others are generally applicable in the context of a corporate acquisition, be it hostile or friendly. These include, for example, the reorganization rules and the rules of sections 337 and 338. Changes in these general rules have been suggested from time-to-time.[48] Other changes have been suggested which are more narrowly targeted against hostile acquisitions and hostile acquisitions attempts. Some of these are described below. All involve important policy issues, tax and non-tax, as well as significant technical difficulties.

"Greenmail"

S. 420 (Senators Boren and Nickles) would impose a 50 percent nondeductible excise tax on certain persons realizing "greenmail" profits. The tax would be imposed only on gain realized on the sale or exchange of stock in a corporation by a 4-percent shareholder (after application of the attribution rules of section 318) of the corporation who held the stock involved for less than 2 years if there was a public tender offer for stock in such corporation during the 2-year period ending on the date of realization (or, in the case of S. 476, a 4-percent shareholder submitted a written proposal to such corporation setting forth a plan involving a public tender offer). Both bills defines "public tender offer", and both contain exceptions for certain persons.

S. 632 (Senator Chafee) would make it clear that the payor of greenmail (generally as defined in S. 420) would be entitled to no deduction for amounts paid to redeem its own stock. Nor would a deduction be allowed for payments to reimburse certain persons for expenses paid or incurred in connection with the redemption or the public tender offer.

Interest

S. 420 and S. 632 would disallow deductions for interest paid or accrued on indebtedness incurred or continued to acquire or carry stock in a corporation (or, in the case of S. 632, corporate assets) acquired pursuant to a hostile offer. However, under S. 420, the rule would not apply in the case of a hostile qualified stock purchase by a corporation. A "hostile offer" is defined as an offer to acquire stock of a corporation if such offer is disapproved by a majority (consisting of at least 2 members) of the continuing independent members of the corporation's board of directors. A definition of an independent board member is provided. A "hostile qualified stock purchase" is a qualified stock purchase (sec. 338(d)(3)) if any portion of the stock included in such purchase was acquired pursuant to a hostile offer.

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[48] See, e.g., the report of the staff of the Senate Finance Committee, *The Reform and Simplification of the Income Taxation of Corporations*, S. Prt. 98-95, 98th Cong., 1st Sess., (September 22, 1983); the recent Treasury Department proposal (November 1984); and Joint Committee on Taxation, *Federal Income Tax Aspects of Mergers and Acquisitions* (JCS-6-85), March 29, 1985.

S. 476 would disallow deductions for interest paid or accrued with respect to hostile acquisition indebtedness. "Hostile acquisition indebtedness" means any junior obligation (i.e., "junk" bonds) issued in connection with a hostile acquisition. A "hostile acquisition" includes certain corporate-level transactions involving a target corporation and any other person (or group of persons acting in concert) who acquired at least 20 percent of the stock of such corporation in the preceding 12 months, but only if the corporate-level transaction, before its consummation, was not formally approved by a majority (consisting of at least 2 members) of the independent board members of such corporation. The term "junior obligation means any evidence of indebtedness which is (1) expressly subordinated in right of payment to the payment of substantial unsecured indebtedness of the issuer or the target corporation, (2) indebtedness of a person more than 50 percent of the gross assets of which is (or, following the acquisition, will be) represented by stock of the target corporation, cash, or cash equivalents, or (3) is rated at least 2 ratings inferior to the rating of any other substantial class of indebtedness of the issuer or the target corporation. Certain special rules relating to refinancing, guarantors, and assumptions, etc. are also provided.

Mandatory section 338 election

S. 420 and S. 632 would treat a section 338 election as having been made in the case of every hostile qualified stock purchase. Furthermore, section 337 would not apply for purposes of determining the amount of gain recognized by the acquired corporation as a result of the transaction. S. 632 would provide, in addition, that taxes imposed on the acquired corporation be reason of the deemed section 338 election would not increase the basis of the acquired corporation in its assets.

STATEMENT BY SENATOR JOHN H. CHAFEE

During the past four months at least three Senate committees and three House committees have heard over 100 hours of testimony on the subject of hostile takeovers and related aspects of tax, anti-trust, and regulatory policy.

If no consensus exists yet on the proper solution, there surely is at least a growing recognition that a problem of major proportions exists.

The frenetic pace of corporate takeovers this year and last has set new dollar volume records for mergers and acquisitions.

Without a doubt many of these mergers and acquisitions redeploy underutilized assets, enhance efficiency, raise values, and give shareholders a fairer return than they would otherwise receive.

Hostile takeovers, on the other hand, demoralize companies, disrupt local communities and pressure top executives into wasteful defensive tactics and a focus on the short-term rather than a long term future. Hostile takeovers—assaults on the company by corporate raiders—have reached epidemic proportions leaving most corporate chiefs worried from one day to the next.

To fend off hostile assaults, U.S. corporate chiefs are purposely inflating their debt, paying billions in ransom, and squeezing even more short-term earnings out of their operations—all at a heavy cost to long-term competitiveness.

To avoid a hostile takeover, management's attention must be riveted on the short-term, lest quarterly results lag; crucial investments in the firm's long-term health may be deferred or not made at all. Preparation for a possible takeover attempt involves countless hours spent studying, discussing and implementing offenses and defenses. Meanwhile, development of new products and services, or improvements in technology, process or efficiency fail to receive the undivided attention they must. Once as hostile bid is underway, some managements employ measures that may represent costs which will take many years to recover.

These hostile takeovers, utilizing high-risk financial vehicles, enjoying the benefits of our tax laws, are aimed at short-term profits for professional speculators at the expense of long-term economic performance. Today's price per share is all that matters; the stock markets accommodate speculators rather than investors.

The Business Roundtable and Wall Street writers refer to this activity as "the takeover game." I suggest we call it by a more accurate name . . . "the sting." Game implies that no one gets hurt. Surely by now it's evident that is not the case. Shareholders, certainly those in the second tier of the "two tier" tender offer are more than likely to come out losers.

Where liquidation turns out to be the end result of a hostile takeover, communities that are home to forsaken plants, and employees who worked there for many years are clear losers.

There are other losers whose identities won't be known until the next sharp business downturn occurs. They are the small investors whose money flows through institutional funds into high risk junk bonds. They are also the new issuers of junk bonds, now so laden with debt that even a modest shortfall in cash flow could have dire consequences.

This year we are seeing the largest junk bond default ever. On March 1, Sharon Steel Corporation failed to make interest payments on some $426 million in low rated debentures. Imagine the situation if we experience an economic slowdown.

Most new junk bond issues (about $24 billion) have been floated during the last three years, a time of expansion and generally declining interest rates. The interest rates which these junk bonds carry are higher than the rates or return the underlying businesses are likely to earn in periods of economic downturn. The next time we have a recession, there's going to be a lot of fallout, as cash flow slows and is no longer available to service the massive debt that is substituted for equity in today's particular brand of takeovers.

Yet there are some obvious winners in this operation I'd like to call "the sting"—the raiders. They make a lot of money, they make it in a hurry, and they make it the "new fashioned" way, either through greenmail or bust up liquidations. They put a company into play and eventually walk away winners despite the outcome. From their standpoint, it's "heads I win, tails you lose!"

Certainly the speculators and arbitragers are winners. Once "in play" the upward spiral in a company's stock prices is easily predictable. Their only risk seems to be whether their Wall Street Journal will be delivered on time, and whether they can beat the rush to their broker.

The investment bankers who specialize in junk bonds certainly are not the losers. They command very fat fees for raising a billion dollars faster than most of us can get a mortgage approved on our house.

This kind of activity is not in the national interest. It is hardly a laughing matter despite the very colorful terminology that has developed around it. We cannot continue to call it a game because the loss to the public—communities, employees, customers, suppliers—is too great. The potential loss to our economy in case of a slowdown could be disastrous. The implications for our Nation's continued competitiveness, prosperity, security and quality of life demands critical response.

Hostile takeovers undermine our economic system and our competitiveness in a way we can ill afford. The massive debt being borne by target companies either as a result of a completed takeover or to defend against one further exacerbates the direction in which our economy is moving. Our Government faces massive budget deficits. Our resulting trade deficit is alarming. The influx of foreign capital to finance these deficits has made us the biggest debtor nation in the world. This leveraging of America is a trend the Senate cannot responsibly ignore.

In order to finance their recapitalizations and buyouts, management is selling assets, cutting back on capital expenditures, and cutting back on operating expenditures like research and development.

The neutrality which the Williams Act was enacted to ensure no longer exists in this market for corporate control. By adoption of the Williams Act in 1968, Congress intended to protect investors. But a major aspect of the effort to protect the investor was to avoid favoring either management or the takeover bidder. There is a decided tilt in favor of the hostile bidder in this most recent wave of hostile takeovers.

There are many explanations for this, not the least of which is found in our income tax laws. Our Government actually subsidizes hostile bids by permitting not only the full deductibility of interest on debt borrowed by the raider to finance deals, but also a write-up of the target's assets with a corresponding reduction in taxes and increased cash flow. Furthermore, the tax laws are being interpreted by some tax attorneys to allow the deduction of greenmail settlement payments as a business expense.

I have introduced two legislative proposals intended to improve the ground rules for conducting hostile takeovers. One is the Tender Offer Reform Act of 1985 (S. 631), a comprehensive approach to this whole problem of hostile takeovers, which amends the securities laws to require approval of tender offer transactions on both the bidding and target sides. This proposal also requires more extensive disclosure about the raider's plans for the target company if the tender offer is consummated.

The legislation we are considering here today is S. 632 which amends the Internal Revenue Code to address the way present tax laws reward hostile corporate raiders. These tax changes would ensure the oft-espoused government "neutrality" during a takeover battle.

The legislation I have proposed is obviously not perfect. I await the suggestions of our witnesses today on how we can improve upon these proposals or what other legislative action might be more appropriate to correct this menacing problem, while preserving a healthy free market.

Public confidence in the integrity of our securities markets is rapidly eroding. The appearance of excessive speculation in takeovers—the corporate raiders who "jump into the market for the quick buck" without regard for anything else—is very much in the public's consciousness.

Congress therefore has an obligation to understand how this new "sting" works, and to consider corrective measures if that's what it takes to put the free enterprise system back on the right track. Passage of legislation that restricts the deductibility of interest on junk bonds when they are used to finance such takeovers would be a good place to start.

STATEMENT OF SENATOR BOREN

Mr. Chairman, while much has been said about the ill effects of corporate mergers, it would be wrong to suggest that all mergers are bad. Many voluntary mergers have combined research resources and marketing capabilities to enhance the ability of the new unit to compete in the world markets. With the ever increasing interdependence among U.S. and the world economies, we can no longer afford to take just a domestic view. We must recognize the importance of our ability to compete abroad and we must not underestimate the contribution to that effort that voluntary mergers can make under appropriate circumstances.

It is also true, that not all hostile mergers are bad. Sometimes an ineffective management team needs to be replaced. Where the management has not done enough to maximize stock performance and a more efficient use of corporate resources is available, hostile corporate takeovers may help accomplish these tasks to the benefit of the stockholders and the economy at large.

While I acknowledge that mergers can in some instances be helpful, the economic justification for two-tier hostile takeovers is more difficult to establish since the same offer is not extended to all stockholders. It is hard to see how all stockholders could be said to benefit when a few stockholders receive higher prices for their stock than the average stockholder. It is also hard to see how it could be said that all stockholders are benefited when a small group of stockholders, by threatening a takeover, receive what is commonly called "greenmail" payments for the stock they may end up holding for only a very short time. These are payments which other rank and file stockholders do not receive. It is difficult to understand how it is in the long range best interest of the country for this to happen, particularly when one considers that such payments use cash that could better be used for research and development, modernization of plant, or other investment purposes which are critical to remaining competitive. Instead, the cash is diverted to speculators who have no interest in the long range productivity of the company.

Business investment priorities are further distorted by merger activity. Not only are the alternative uses of cash skewed, but so is the ability to borrow. While a target company may want to borrow for expansion, its creditors will limit how much they loan based on the perceived ability to repay from anticipated cash flow. On the other hand, those who attempt to takeover that very same corporation may be able to get their creditors to stretch the value of the target balance sheet much further since liquidation value rather than anticipated cash flow is the critical factor. This clearly a bad situation.

Use of so-called "junk" bond financing where the loan is secured only by the anticipated value of the assets of the target company, is also very questionable in situations where used in a two-tier hostile takeover attempt or where used leverage a "greenmail" threat. In the recent stock play by Carl Icahn against Phillip's Petroleum Company, it was clearly contrary to the national interest, the interest of the company, its stockholders, and employees, for the greenmail payment to have been brought about by the leverage power of junk bonds. Even if Icahn had used the junk bond route to prevail in the takeover, it would still not serve the national interest because the company would, of necessity, have been dismantled to retire the debt. The cannibalization would occur without concern for the well-being of the community, the employees and their families, the retirees, or the long run impact on domestic energy production.

It is particularly inappropriate that the tax code is not even neutral in these situations but rather it appears to encourage greenmail and takeovers by junk bond financing by (1) allowing the deductibility of the interest expense, (2) allowing the stepping up of the basic of assets acquired without triggering a taxable gain to the acquired company, and (3) allowing the potential for lower tax rates on appreciated stock by giving it capital gains treatment.

The current climate affects not only those associated with companies already taken over and those not at play, but also all companies who may anticipate attack. Uncertainty on their part has been the impetus for defensive actions which are designed either to make the company unattractive to a possible pursuer by overburdening the healthy company or to make short term profit a priority over long term productivity so as to get the price of the stock up too high to continue to be attractive as a possible takeover target. Neither reaction bodes well for the future economic health of our country.

Thus, while we want to be careful to take a rifle shot approach so as not to disturb the potentially beneficial results of some mergers, we must stop the abuses and ill effects of two-tier hostile corporate takeovers. In my opinion, legislation which I and others have introduced in the Senate (S. 420 and S. 476), and which Congressman Jones has introduced in the House, takes such as approach by (1) disallowing the deductibility of interest on junk bond financing of hostile two-tier takeover attempts (2) imposing an excise tax on greenmail profits; and (3) by requiring a mandatory section 338 election to stop the current situation in which the raiding company steps up the basis of that acquisition without triggering a tax upon the gain realized by the targeted company. We should not let the raider have his cake and eat it, too.

It is critical that we stop the use of the tax code to subsidize the utilization of larger sums of precious credit for corporate takeovers which not only fail to increase productivity but in many cases reduce productivity, reduce investment in research development and reduce employment. This is an issue which is of vital concern not only to Oklahoma but to the nation as well.

With credit so badly needed by farmers, small businesses and those wanting to modernize their plants, it is simply wrong to allow speculators, motivated purely by personal gain, to get tax benefits to use up precious capital resources to destroy responsible corporate citizens and imperil thousands of jobs.

I wrote Chairman Packwood on February 6, 1985 seeking hearings so that we might "fully investigate the use of "junk bond" financing to see how widespread it has become and who is using it and the tax incentives which may be encouraging its use in the case of two-tier hostile takeovers and the potential impact on credit markets and financial institutions." I am pleased that the day has arrived in which we may focus our attention on these problems.

As we listen to the testimony this morning, I want everyone to know that I am not wedded to every detail of the proposed changes I have put in my legisaltion. I am open to constructive criticism, to corrective commentary. If approaches that suggested by others better stand the test of today's inquiry, then this hearing will have served the purpose I anticipated in my Febraury letter to Senator Packwood.

I hope that today's hearing will enable us to focus on the problems created by the waive of takeovers and the debt—laden companies that result from them. I hope the believers in the free market, of which I most assuredly count myself as one, will acknowledge that there is a "before" tax free market and an "after tax" free market and that not only what we may or may not do here today changes the market forces in each case, but also what has been done or left undone in years past. In other words, to answer all attempts to deal with these problems with an espousal of one's faith in the proverbial "free market" ignores the fact that market forces may already be skewed by current tax law in need of change.

I thank the Chairman, both The Chairman of the Full Committee and of this subcommittee for today's hearing.

Senator **CHAFEE**. I want to welcome everybody here today.

This is the day of hearings we are going to have on the Hostile Takeover matter.

During the past 4 months at least, three Senate committees and three House committees have heard a 100 hours of testimony on the subject of hostile takeovers. If no consensus exists on the proper solution of this matter, there is at least a growing recognition that a problem of major proportions exists.

The frenetic pace of corporate takeovers this year and last has set a new dollar volume for mergers and acquisitions. Without a doubt, many of these mergers and acquisitions redeploy underutilized assets, enhance efficiency, raise values, and give shareholders a fairer return than they would otherwise receive.

On the other hand, and I think we have to recognize this, hostile takeovers demoralize companies, disrupt local communities and pressure top executives into wasteful, defensive tactics, and focus on the short-term rather than the long-term future.

Hostile takeovers' assaults on the companies by corporate raiders have reached epidemic proportions, leaving most corporate chiefs worried from one day to the next.

To fend off hostile assaults, U.S. corporate chiefs are purposely inflating their debt, paying billions in ransom, and squeezing even more short-term earnings out of their operations, all at a heavy cost to long-term competitiveness.

To avoid a hostile takeover, management's attention must be riveted on the short term, lest quarterly results lag. Crucial investments in the firm's long-term health may be deferred or not made at all.

Preparation for a possible takeover attempt involves countless hours spent studying, discussing, and implementing offenses and defenses. Meanwhile, the development of new products and services or improvements in technology, process, or efficiency fail to receive the undivided attention they must.

These hostile takeovers utilizing high-risk financial vehicles enjoy the benefits of our tax laws, and they are aimed at short-term profits for professional speculators to the expense of long-term economic performance.

The Business Roundtable and Wall Street writers are referring to these activities as a "takeover game," and I think that is too mild a term; to me it is a form of warfare.

Where liquidation turns out to be the end result of a hostile takeover, communities that are home to forsaken plants and employees who worked there for many years are the clear losers. But there are other losers whose identities won't be known until the next sharp business downturn occurs. They are the small investors whose money flows through institutional funds into high-risk junk bonds. They are also the new issuers of junk bonds, now so laden with debt that even a modest shortfall in cash-flow could have dire consequences.

This year we are seeing the largest junk bond default ever. On March 1, Sharon Steel Corp. failed to make interest payments on $426 million in low-rated debentures. Imagine the situation in this Nation if we truly face an economic slowdown.

Most new junk bond issues, about $24 billion, have been floated during the last 3 years, a time of expansion and generally declining interest rates. The interest rates which these junk bonds are carrying are higher than the rates of return the underlying businesses are likely to earn in a period of economic downturn. The next time we have a recession there is going to be a lot of fallout as cash-flow slows and is no longer available to service the massive debt that is substituted for equity in today's particular brand of takeover.

Yet there are some obvious winners in this operation, and they are the raiders. They make a lot of money, they make it in a hurry, and they make it in a new-fashion way: either through greenmail or bustup lidquidation. They put a company into play and eventually walk away winners, despite the outcome. From their standpoint, all to frequently it is, "Heads, I win; tails, you lose."

The investment bankers who specialize in junk bonds certainly are not the losers; they command very fat fees for raising $1 billion faster than most of us can get a mortgage on our home. This kind of activity is not in the national interest. It is hardly a laughing matter, despite the very colorful terminology that has developed around it. The potential loss to our economy in case of a slowdown, as I said, could be disastrous.

Hostile takeovers undermine our economic system and our competitiveness in a way we can hardly afford. The massive debt being borne by target companies, either as a result of a completed takeover or to defend against one, further exacerbates the direction in which our economy is moving.

Now, the neutrality, which the Williams Act was enacted to ensure, no longer exists in this market for corporate control. In this act, which was adopted in 1968, Congress intended to protect investors. But a major aspect of the effort to protect the investor was to avoid favoring either management or the takeover bidder.

There is a decided tilt in favor of the hostile bidder in this most recent wave of hostile takeovers.

Our Government actually subsidizes hostile bids by permitting not only the full deductibility of interest on debt borrowed by the raider to finance the deals, but also a writeup of the target's assets with a corresponding reduction in taxes and increased cash-flow.

Furthermore, the tax laws are being interpreted by some tax attorneys to allow the deduction of green-mail settlement payments as a business expense.

Now, I have introduced two legislative proposals intended to improve the ground rules for conducting hostile takeovers. One is the Tender Offer Reform Act of 1985, and that of course deals with the SEC side of it.

The legislation we are considering here today is S. 632, which amends the Internal Revenue Code to address the present tax laws rewarding hostile raiders. These tax changes would ensure the oft-espoused Government neutrality.

Now, the legislation I have proposed may not be perfect. I await the suggestions of our witnesses today, and indeed the first two witnesses themselves have legislation on this matter.

What we are concerned about is the public confidence in the integrity of our security markets. The appearance of excessive speculation in takeovers, the corporate raiders who jump into the market for the quick buck without regard for anything else, is very much in our minds. It seems to me that Congress has an obligation to examine how this operation works and to consider corrective measure if that is what it takes to put the free enterprise system back on the right track.

So we look forward to the testimony today, and we believe it will be helpful.

Senator Long, we welcome you here. Do you have a statement?

Senator LONG. No statement, Mr. Chairman.

Senator CHAFEE. All right now, we have three witnesses, all from Oklahoma. And I think you have decided that Mr. Jones who has an urgent appointment will go first. So we welcome you here, Congressman Jones, and why don't you proceed.

STATEMENT OF HON. JAMES R. JONES, A U.S. REPRESENTATIVE, STATE OF OKLAHOMA

Mr. JONES. Thank you very much, Mr. Chairman, Senator Long, members of the committee.

I am delighted to be here and to share this witness table with my colleagues from Oklahoma, David Boren and Don Nickles, and I appreciate your consideration in allowing me to testify so that I can get to a plane.

Let me commend you, Mr. Chairman, for the leadership you have taken on this issue, on corporate combinations and corporate acquisitions.

In addressing this issue and trying to draw legislation, I have asked myself two questions that I think would be questions the committee should consider. One is whether the Tax Code currently assists in financing mergers and certain types of merger tactics, and, two, if the effect of the Tax Code on the type of merger activity we are witnessing is indeed harmful. I answered Yes to both of those questions, and I would like to consider them in reverse order.

First of all, let me state that there is no justification to claim that all mergers are bad. In fact, many hostile acquisitions are good. Evidence that most mergers improve market resource allocation and stimulate effective corporate management is ample, and therefore we should not seek to interfere with or prevent legitimate economic activity that is a natural process in a healthy, growing economy. We should not restrict unduly investors and company managers' ability to merge capital, nor should we discard shareholders' rights to replace lackluster management. On these points I agree with most of the investment community who will testify today.

But one does not need to disagree with those individuals who argue that mergers are essentially transactions involving the redeployment of assets in order to argue that there are valid reasons to be concerned about certain limited types of merger tactics, or to be concerned that there is a danger in liquidation, two-tiered takeover methods. I believe these takeover tactics are indeed an abuse of the free market process, and I would like to explain why.

First of all, these liquidation mergers are creating too much corporate debt in the United States. One of the major factors we found on the House side in testimony that raiders select in identifying potential targets is whether a corporation is underleveraged. This means, presumably, a corporation is not an attractive target if its financial statement is replete with a death-laden balance sheet. In other words, the corporation which takes steps, even risky ones, to eliminate virtually all of its corporate tax liability is to be commended. On the other hand, the firm that takes measures conducive to long-term growth and risk taking by properly capitalizing its financial structure with equity capital should be considered ineffective management and a target for takeover.

Our latest case study on this, one on which we are very sensitive to at this witness table, Phillips Petroleum, shows that liquidation-raiding tactics bring about a tremendous increase in a company's debt structure. The company has rewritten its financial report with a balance sheet that increased debt from 23 percent of total capital to 81 percent, and it is difficult to believe that that situation has created a company more able to face future investment demands and that it will be more vigorous in replacing depleting oil reserves.

The drastic increase in debt financing from corporate takeovers is really overleveraging corporate America, and I think we all recognize that this is happening at a time when the economy is growing. A very serious question that needs to be asked is what will happen once we enter a recession which is a natural part of the business cycle. I think this is something the Federal Reserve Board has already cautioned financial institutions to be concerned about, and I would encourage you to probe this question more deeply.

Second, these liquidating mergers impair long-term growth and planning. When companies struggle to avoid becoming targets by pushing share prices upward and making quarterly earnings reports look better, management's focus is only on short-term results, and the first thing they forget about is tomorrow.

I noted a few years ago, when I chaired the House Task Force on United States-Japan Trade, that one of the major shortcomings in American management that makes us less competitive with say the Japanese is our absolute fanatical need to deal with short-term or the quarterly earnings reports. And the Japanese, on the other hand, have much more long-term thinking. Well, this practice of hostile takeovers, greenmail operations, and things like that forces corporate management to think in an even shorter terms, and that does not help our long-term competitiveness.

Third, liquidation mergers have not installed better corporate management. Few practitioners would disagree with the proposition that the hostile takeover bidder now holds most of the cards in corporate takeover contests. Nor would many disagree with the premise that liquidation raiders have little in mind but to make a fast buck. Their real motivation is not better management, it's big money.

I would commend to the committee's attention a study that the Columbia School of Law presented to the House Energy and Commerce Committee. One of the witnesses, based on that study, concluded that there is no basis to the argument that mergers on the average replace lackluster or inefficient management.

You might also take a look at a case study of Mesa Petroleum's present attempt to take over Unical and determine which of those companies are better managed.

Finally, let me say that liquidation breakups based on replacement cost prices insure destruction of healthy corporate operations, and I believe that this is an abuse of the free market system.

The most recent data available indicates that the average market value of traded stock in proportion to the average replacement costs of assets reflected by such stock is 0.654 to 1. The ratio, however, of average acquisition costs of the corporation to its overall replacement cost is 0.98 to 1. If raiders are willing to bid up prices and tender offers near the replacement cost price of the assets held by the target entity, this assures that the target's ongoing corporate activity must be substantially if not entirely curtailed. In many cases, we are assured of eventual liquidation.

Now, whether the Federal Government should be a silent partner in such activity is a serious question. And to me, the answer is that we should keep the Federal Government out of the role of underwriting these liquidation takeovers.

So for the reasons I have stated, I think that these hostile takeovers and greenmail are indeed an abuse of the free market system.

Now, what our bill attempts to do, H.R. 1100, on the House side, of which I am principal sponsor along with over 60 cosponsors, and S. 476, introduced by Senator Boren and several of his colleagues on this side——

Senator CHAFEE. Is that the same legislation?

Mr. JONES. It is identical legislation. Yes, sir.

First of all, it would basically end the universally condemned practice of greenmail. And I don't think I need to go into that in any more great detail.

Second, it would put a cold shower and a great chill on the use of junk bonds to finance hostile takeovers by disallowing the deductibility of the interest paid on those junk bonds.

Now, basically, Congress has looked at this question before, as to the fine line between this subordinated debt instrument, and equity. We looked at in 1969 and then later in regulations in 1980.

Basically what we do is to say that this really is equity and that the Federal Government should not finance this by making the interest deductible.

So those are the two main features of my legislation. As you said in your opening statement, Mr. Chairman, your bill may not be the answer. We don't claim that our bill is the sole answer. But we do believe that this practice needs to be stopped or at least a very serious chill needs to be placed on it. We think the approach that we make in our legislation achieves this purpose puts that chill, without unduly interfering, in the marketplace. We hope very much that this committee will look seriously at the legislation.

I appreciate very much this chance to testify.

[The prepared statement of Hon. James R. Jones, a U.S. Representative from Oklahoma, follows:]

STATEMENT OF THE HONORABLE JAMES R. JONES
BEFORE THE FINANCE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
APRIL 22, 1985

The Subcommittee today focuses on corporate combinations and corporate acquisitions. I am very pleased to discuss some of the more significant Federal income tax provisions which influence decisions on corporate changes of ownership.

There is hardly a day that passes that the newspapers are not filled with headlines about another multi-billion dollar tender offer transaction. To the public, the world of business now appears to be a jungle ruled by laws that even Darwin would find harsh.

With this dramatic increase in the number and volume of corporate combinations in recent days, a debate has been escalating in Congress as to what degree the U. S. Treasury has aided and abetted this merger mania through our tax laws.

Mr. Chairman you are to be commended for your role in bringing these issues before the American public.

Let me try to summarize our inquiry in this way. There are two questions I feel we should consider: (1) whether the tax Code currently assists in financing mergers and certain types of merger tactics; and (2) if the effect of the tax Code on the type of merger activity we are witnessing is harmful.

My premise is that both of the questions must be answered in the affirmative. My testimony today will consider them in reverse order.

I. The Number and Method of Corporate Combinations Raise National Issues that Deserve Thoughtful Analysis

Let me begin by stating my bias on the issue of whether corporate combinations are harmful. There is no justification to the claim that all mergers are bad. It is also true that some, in fact many, hostile acquisitions are good. There is ample evidence that most mergers improve market resource allocation and stimulate effective corporate management. Therefore, we should not seek to interfere with or prevent legitimate economic activity that is a natural process in a healthy, growing economy. We should not restrict investors' and company managers' ability to merge capital. Nor should we discard shareholder rights to replace lackluster management.

On these points I agree with most of the investment community who will testify today.

But one does not need to disagree with those individuals who argue that mergers are essentially transactions involving the redeployment of assets in a manner that realizes greater values for the shareholders,[1] in order to argue that there are valid reasons to be concerned about certain, limited types of merger tactics; or, to be concerned that there is a danger in liquidation, two-tiered takeover methods. I believe these takeover tactics are an abuse of the free market process, and a matter for Congressional concern. Let me explain why.

A. Liquidation mergers are creating too much corporate debt.

During the first Ways and Means Committee hearing we heard comments on what raiders look for in potential targets. One of the major factors raiders select in identifying potential targets is whether a corporation is under-leveraged.

This means, presumably, a corporation is not an attractive target if its financial statement is replete with a debt-laden balance sheet. Somehow, the raiders would have us believe that such debt-heavy corporations represent what they consider "effective corporate management." I guess, moreover, this is also what the Council of Economic Advisors means when it says takeovers "help recapitalize firms so that their financial structures are more in line with prevailing market conditions."[2]

What Congress is being told, in other words, is that the corporation which takes steps, albeit risky ones, to eliminate virtually all of its corporate tax liability is to be commended. On the other hand, the firm that takes measures conducive to long-term growth and risk taking by properly capitalizing its financial structure with equity capital, should be considered ineffective management.

Our latest case study, Phillips Petroleum, shows what good liquidation raiding tactics accomplish. The company has rewritten its financial report with a balance sheet that increased debt from 23 percent of total capital to 81 percent. It is difficult to believe that situation has created a company more able to face future investment demands, and that it will be more vigorous in replacing depleting oil reserves.

Strong arguments can be made that the drastic increase in debt-financing from corporate takeovers is over-leveraging corporate America.[3] Moreover, there is legitimate concern as to whether they will continue to be able to service this heavy debt burden. Most takeovers have added this debt to balance sheets at a time when the economy is growing. What will happen once we enter the next recession? The Federal Reserve Board has already cautioned financial institutions about this concern. Let me encourage you to probe this question with them.

B. Liquidating Mergers Impair Long-term Growth and Planning.

When companies struggle to avoid becoming targets, by pushing share prices upward and making quarterly reports look better, management's focus is only on short-term results. The first thing they forget about is tomorrow.

One leading tax expert put it this way: "One can analogize the situation to a farmer who does not rotate his crops, does not periodically let his land lie fallow, does not fertililze his land and does not protect his land by planting cover and creating windbreaks. In the early years, he will maximize his return from the land. It is a very profitable short-term use. But invariably it leads to a dust bowl and economic disaster."

We are forgetting to plant the seeds that produce long-term growth and prosperity. Tomorrow our corporate assets will be dismembered. This myopic vision in corporate planning is something we are ill-prepared to sustain.

At a time when we are calling upon the Congress to enact protectionist measures against our Japanese trading partners, it makes little sense to ignore the domestic policies which influence our battle to compete in international markets. There will be no war for the telecommunications market if we forego long-term research and development.

C. Liquidation Mergers have not Installed Better Corporate Management.

Few practioners would disagree with the proposition that the hostile takeover bidder now holds most of the cards in takeover contests.4/ Nor would many disagree with the premise that liquidation raiders have little in mind but to make a fast buck. Their real motive is not better management; it's big money.

In fact, most credible evidence suggests that acquirers have no better management than the targets. A study discussed in testimony before the House Energy and Commerce Committee, conducted at the Columbia School of Law found that, "the industrial company targets of hostile takeovers in 1981 had an average return on equity over a full four year period of 16 percent. Yet only once in the past decade has the return for all manufacturing corporations been above 15 percent."5/ This study led that witness to conclude: there is no basis to the argument that mergers, on the average, replace lackluster or inefficient management.

It appears the raiders claim that they are seeking to replace entrenched management, may be referring to their own company's management.

D. Liquidation Breakups Based on Replacement Cost Prices Insure Destruction of Healthy Corporate Operations.

The most recent data available indicate that the average market value of traded stock in proportion to the average replacement costs of assets reflected by such stock is .654 to 1. The ratio, however, of average acquisition costs of a corporation to its overall replacement costs is .98 to 1.

It is argued, therefore, that an acquirer could pay 50 percent above the previous stock market price and still buy the average firm for less than its replacement costs.6/ Why is this important?

The debate as to why the stock market values corporations well below the replacement cost of their assets is best left to the nation's economists. My reason for mentioning this fact today is simply to illustrate the ramification of our policies.

If raiders are willing to bid up prices in tender offers near the replacement cost price of the assets held by the target entity, this assures that the target's ongoing corporate activity must be substantially, if not entirely, curtailed. This is evidenced by the fact that the stock market is not willing to sustain a share price level that even closely approximates the replacement, purchasing cost threshold. We are assured of eventual liquidation.

It seems appropriate, therefore, for Congress to ask itself whether the federal government should be a silent partner in such activity. To me the answer is that we should keep the federal government out of the role of underwriting these liquidation takeovers.

II. The Role of the Internal Revenue Code in Breakup Liquidation Takeovers

The current tax system is a significant factor in the wave of breakup liquidation takeovers. My legislation has one simple purpose: to get the government out of the business of participating in liquidation acquisitions without hindering the legitimate movements of capital that are necessary in our free market system. My bill, H.R. 1100, legislation with over sixty cosponsors, has gained bipartisan support among members. S. 476, introduced by Senator Boren is identical to my bill.

First, our legislation would end the universally condemned practice of greenmail. Greenmail, as you know, is the speculator's version of blackmail. It occurs when a speculator buys up a large block of shares in a publicly-traded company, with no purpose beyond threatening the corporation into buying back the shares at a premium. The provision in H. R. 1100 is mirrored after what the Committee enacted on golden parachutes during the 1984 Tax Reform Act.

Second, our legislation would reduce the interest deduction that is now allowed for indebtedness incurred in corporate acquisition. The current tax code already restricts deductions for this purpose; my bill would increase this restriction by denying the deduction when a takeokver is funded by junior obligation debt--known in the trade as "junk bonds."

Why am I concerned about junk bonds? To answer accurately this question it is necessary to review the legislative history behind two provisions in the Code, 279 and 385.

Where to draw the line between corporate equity and corporate debt is a question Congress has pondered for a number of years without adequate resolution. The manner in which we resolve the distinction is very important in a tax structure that allows interest paid on debt to be deductible, but dividends paid to shareholders on equity are not. As long as we have a system of double taxation of corporate profits, the distinction between equity and debt will be of great importance. Allowing corporate entitities to treat certain investment as debt rewards them with great tax savings.

Today, when we are witnessing a wholesale restructuring of corporate balance sheets, the potential for wiping out most corporate tax liability is very real. As debt replaces equity, that means that approximately one half of the burden of financing corporate ownership is put upon the Federal Government.

That is the reason, in 1969, Sections 279 and 385 were added to the Code, in large part to reduce tax incentives for then-prevalent corporate merger activity. 385 gives the U. S. Treasury the authority to promulgate regulations on how to distinguish between debt and equity. However, after a delay of ten years, the regulations that were promulgated in 1980, were far from satisfactory. The final regulations were withdrawn, leaving us today with prior case law, and few published rulings to guide the Service in judging between debt and equity.

Section 279 imposed limitations on the ability of an acquiring firm to issue subordinated convertible bonds that allowed the acquirer to pay for the acquisition through the interest deduction. Since a debt instrument must satisfy a number of statutory safe harbors before the interest is disallowed, however, today 279 is easily avoided. Therefore, it is time to make these current provisions of the Code more workable in light of today's sophisticated investment practices.

Our bill would treat junk bonds as equity when certain tests are met. The reason for taking this step is that when corporate mergers are financed with junk bonds the distinction between equity and debt completely blurs. Left unchecked, conventional equity ownership would disappear. And, what this means for our tax system is that these transactions have the potential of wiping out the corporate income tax liability of companies subject to such raids. If we want to adopt a system of corporate tax integration, we should simply leave unfettered the practice of financing corporate acquisitions with junk bond financing.

These two areas are provisions I feel the Committee should act upon immediately, without waiting for the long-term Subchapter C project which is under consideration. We cannot afford to wait for the utopia of tax reform in the area of corporate taxation. Even all of the major tax reform proposals fail to address the problems replete through Subchapter C.

In conclusion, let me restate what our inquiry means for corporate America. Our inquiry, contrary to vociferous allegations, does not mean that we believe all mergers are implicitly bad. Nor does action on our part indicate that we are seeking to protect incumbent management. Should we conclude that specific legislative proposals are appropriate, that does not mean we intend to discourage mergers. Most importantly, it is helpful to keep in mind, that it is not necessarv to conclude mergers are primarily motivated by tax Code provisions in order to justify remedial actions under our tax laws.

Whether mergers are good or bad, it is time the U. S. Treasury stop footing the bill for one half of the cost. That is what I am attempting to accomplish through H. R. 1100.

Senator CHAFEE. Well, thank you very much, Congressman, for being here. I know you have time constraints.

Senator Long.

Senator LONG. No questions.

Senator CHAFEE. Senator Domenici.

Senator DOMENICI. No, I will be down there shortly.

Senator CHAFEE. All right, fine. Thank you very much for coming. We appreciate it.

Mr. JONES. Thank you.

Senator CHAFEE. Senator Boren.

Senator BOREN. Thank you very much, Mr. Chairman.

I will apologize first to the committee in saying that I am going to have to leave very rapidly to go to a meeting at the White House on Nicaragua this morning, and I apologize. I hope I will be able to return and join the chairman and the members of the committee in listening to more of the testimony later this morning.

I first want to commend my colleague, Congressman Jones, who has introduced this same bill on the House side as Senator Nickles and I have introduced on this side. And I want to commend you, Mr. Chairman, also for your interest in this area and for the legislation and legislative initiative which you have shown in introducing Senate bill 632.

While much has been said about the ill effects of corporate mergers, as Congressman Jones has indicated, it would be wrong to suggest that all mergers are bad. Many voluntary mergers have combined research resources and marketing capabilities to enhance the ability of the new unit to compete in world markets. And with the ever-increasing interdependence between the U.S. and world economies we can no longer afford to take just the domestic view; we must recognize the importance of our ability to compete abroad and we must not underestimate the contribution to that effort that voluntary measures can make under appropriate circumstances.

I would say also, it is also true that not all hostile mergers are bad, as has already been said. Sometimes an ineffective management team needs to be replaced. Sometimes the interests of the shareholders are not being adequately represented.

So therefore, while there are problems with corporate mergers that need our attention, we must be careful in crafting a remedy to target the abuses while not preventing the legitimate economic activity to which I have referred.

I also believe that we should attempt to interfere with the free market as little as possible in crafting any remedy.

While I acknowledge that mergers can in some instances be helpful, the economic justification for two-tier or multitier hostile takeovers is more difficult to establish since the same offer is not extended to all stockholders. It is hard to see how all stockholders can be said to benefit when a few stockholders receive higher prices for their stock than the average stockholder.

It is also hard to see how it could be said that all stockholders are benefited when a small group of stockholders, by threatening a takeover, receive what is commonly called greenmail payments for the stock they may end up holding for only a very short period of time. These are payments; these greenmail payments are not received by other rank and file stockholders. It is difficult to understand how it is in the long-range best interest of the country for this to happen, particularly when one considers that such payments use cash that could be better used for research and development, modernization of plant, or other investment purposes which are critical to our remaining competitiveness, instead of being diverted to speculators who have no interest in the long-range productivity of the company.

As Congressman Jones has already indicated, also, business investment priorities are further distorted by merger activity. The fear of hostile takeovers often leads the management of companies not to make the best long-range decisions for the future of a company.

I think, Mr. Chairman, as you have indicated in your own legislation, it is particularly inappropriate that the Tax Code is not even neutral in these situations, but rather it appears to encourage greenmail and takeovers by junk bond financing by first allowing the deductibility of interest expenses; second, by allowing the stepping up of the basis of assets acquired without triggering a taxable gain to the acquired company; and, third, by allowing the potential for lower tax rates on appreciated stock by giving it capital gains treatment.

So I think we must be very careful, take a rifle-shot approach in any legislative remedy that we craft. I think that the basic approach taken in the bills which we have mentioned is a sound one; it does disallow the deductibility of interest on junk bond financing of hostile two-tier takeovers; it does impose an excise tax on greenmail profits, a 50-percent nondeductible excise tax on greenmail profits.

Senator CHAFEE. That's like we did with the golden parachute. Is that the same thing?

Senator BOREN. That is correct. And the tax would apply, Mr. Chairman, to the entire gain earned by a shareholder owning 4 percent or more of the voting stock, if the shareholder holds the stock for less than 2 years, and if there is a public tender offer required to be filed with any Federal or State agency.

So I think by providing a strong disincentive for greenmail, by imposing a high tax on it, we will go a long way toward taking care of the problem.

It also requires a mandatory section 338 election to stop the current situation, where the rating company steps up the basis of that acquisition without triggering a tax on the gain realized by the targeted company. It is allowing the raider, in a sense, to have his cake and eat it too.

This is a growing problem. It has not slowed down. In April alone we have had some $12 billion of additional tenders in several situations that are now pending.

As we listen to the testimony this morning, I want you to know and the members of the committee to know that I am certainly not wedded to every detail of the proposed changes which are in our legislation. I too am open to constructive criticism and to corrective commentary. If approaches that are suggested by others better stand the test of inquiry, then the hearing will have served a purpose that I anticipated in my February letter to Senator Packwood and to you requesting these hearings.

In other words, we need to take the best approach that we can. And I would say that we all believe in the free market, but to talk about the free market when free market forces are already being skewed by the current tax law, I think is a misnomer.

So I want to thank you, Mr. Chairman, for holding these hearings. I think there is an urgent need for action, there are abuses that need to be corrected, and I hope that we can carefully craft a solution that will not unduly interfere with the market and will not overstep and prevent those mergers, even those hostile mergers which are justifiable under certain circumstances.

I thank you very much for allowing me to appear this morning.

Senator CHAFEE. Well, thank you very much, Senator Boren. I know you have an appointment at the White House, so that obviously has very high ranking.

Senator Long.

Senator LONG. Nothing right now, Mr. Chairman.

Senator CHAFEE. Senator Danforth.

Senator DANFORTH. No questions, Mr. Chairman.

Senator CHAFEE. All right. If you can straighten out the Contra matter and be back here by 11, you will have done very well.

Senator BOREN. I will try to do that, Mr. Chairman. Thank you.

Senator CHAFEE. Senator Nickles, you are a cosponsor on this legislation. You are in it together, and we welcome you here. I know you have been deeply concerned about this Phillips situation in your State, so why don't you proceed.

STATEMENT OF HON. DON NICKLES, A U.S. SENATOR FROM THE STATE OF OKLAHOMA

Senator NICKLES. Thank you, Mr. Chairman.

I have a statement. If it will be all right with you, I will just enter it into the record.

Senator CHAFEE. That is fine.

[Senator Nickles' written statement follows:]

U.S. SENATOR
Don Nickles
OKLAHOMA

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Statement of Senator Don Nickles
Before
The Senate Committee on Finance
on
The Tax Treatment of Hostile Takeovers
April 22, 1985

Mr. Chairman and Members of the Committee:

There appears to be strong support for restricting the proliferation of corporate takeovers, especially those deemed to be "hostile". The question remains, however....What is the best approach?

The bills introduced into this Congress cover a wide variety of ways to deal with the situation. I have sponsored and cosponsored legislation which would either place a moritorium on hostile acquisitions or tighten the tax laws governing the transactions of mergers and acquisitons. As one who strongly supports the free-market approach to economic growth, it is difficult to craft legislation which addresses the appropriate relationship between the tax laws and the right of free enterprise to conduct its own affairs.

In the past, I have made it clear that I had strong reservations about the mergers that were taking place and I indicated that I would much prefer that some of the merged companies remain independent. As you are aware, many of these mergers and acquisitions have had a direct impact upon the economy and well-being of Oklahoma. The most recent and notalbe of which is Phillips Petroleum.

In response, I have introduced legislation which would disallow the deduction for interest incurred in certain hostile takeovers and impose an excise tax on greenmail. The critical element in all these proposals is the definition of a hostile takeover situation.

If we provide a definition that is too tight, we run the risk of discouraging the efficient and productive use of corporate assets where there is a reasonable measure of agreement between the companies involved. In a review of recent acquistions, we see some proposals that are initially hostile and eventually turn friendly. We must allow for this type of change in any legislation that is passed by the Congress.

I realize this task is extremely difficult in the ever-changing environmen in which corporate takeovers take place. However, as the method used in takeovers changes to avoid certain tax consequences, the code must be revised to accomodate such changes.

Senator NICKLES. Mr. Chairman, just a couple of general comments. I appreciate your interest and also the legislation which you have introduced, and the interest not only by the members of this committee but by the Senate and by the American public as well.

I think a lot of people are concerned about the growing tendencies—and it is a growing tendency—in the amounts of hostile takeovers that are taking place today, and what it means not only to those companies involved and the stockholders and shareholders and the industry involved but also what it means to the economy as a whole.

Just looking at today's Wall Street Journal, it's kind of interesting to see that the summary in Business and Finance section says, "Ted Turner will try to presell some CBS assets to strengthen his $5.4 billion bid." Down a paragraph or two it says, "T. Boone Pickens will continue efforts to gain control of Unocal Corp., despite the company's plans to prop up its stock value by placing 45 percent of its domestic oil reserves in a publicly traded partnership." I don't know if that's good or not for the economy.

Here is another one: "Uniroyal might be willing to spin off some assets to make itself more appealing to potentially friendly suitors in its effort to elude Carl Icahn's possible bid."

Down here it says, "Crown Zellerbach is ordered by a Nevada judge to delay its annual meeting two weeks. The delay could help Sir James Goldsmith press his hostile bid for control."

These mergers affect not just oil companies, however, that is probably where I have spent most of my time. Also, the media attention has been on the multibillion dollar hostile takeover attempts in the oil industry. But I think it is moving throughout all industries, and we have to assess if it is good or not good and whether or not the present tax laws actually subsidize and encourage it.

I think also, we as representatives of the people have to be aware of some of the concerns of the impact of some of these takeovers on some of these companies. Are they healthy for American industry? And are they healthy, really, for the economy as a whole?

I can tell you, in the oil industry I have seen several successful—to some extent—takeover attempts. I say successful from the vantage point of the suitor or for the company that was trying to take over. They made profits. But in looking at those companies that were involved, I doubt that many would say that they were successful.

I look back and see the net result is a lot of medium size companies that have now become part of a very large company. Continental Oil Co. which has large holdings in my home town of Ponca City, OK, has now merged with Dupont. And incidentally, we are seeing thousands of people either retire early or fight a devastating personal impact.

Senator **Chafee**. Of course, that was a friendly takeover, though.

Senator **Nickles**. Well, not necessarily; it was the White Knight. And the same thing with Cities Service. Cities Service ended up merging with Occidental. Cities Service is big in Tulsa, OK. That was their headquarters. The net result has been that there has been thousands of people let go. The refining and marketing divisions have been sold or spun off, and, again, the impact on the community and the people and the individuals—the net result is if you have a fairly medium-sized corporation, many major segments of that organization have to be spun off to retire the debt.

Again, yes, Occidental, that was a White Knight, but they were seeking a White Knight so they could elude the hostile takeover situation. We had a similar situation with the Texaco acquisition of Getty.

Likewise with Gulf. We now have Gulf and Chevron that have merged; so instead of having two very large corporations possibly competing against each other, we now have, again, a situation where a White Knight came in and saved from the hostile takeover. But we also have thousands of people in the Pittsburgh area and elsewhere that are no longer employed. The net result being that we have several companies in my State and throughout the country who are no longer independent companies but who have merged or have been forced to merge or seek a White Knight to elude a hostile takeover. Their fear of the hostile takeover was that they would have to sell off a substantial portion of their assets to pay off the junk bonds or the high debt load that was incurred by those who were behind the hostile takeover.

You mentioned in your statement Phillips Petroleum. They were successful in fending off a hostile takeover situation, but the net result will be billions of dollars of debt. Again, you had a medium-size to large company providing the very valuable function not only in my State but worldwide to elude a hostile takeover now finds themselves incurring billions of dollars of debt. What type of impact that has, I think we all need to take a look at.

Currently under takeover consideration are Unocal, CBS, Uniroyal, and so on—I think we do need to look at the consequences. I have seen some of the negative consequences. And then we have to assess whether or not legislation is the right remedy or not.

I have wrestled with several of the legislative remedies, some of which I have been quite uncomfortable with, some of which, Mr. Chairman, I opposed, because I thought they were bad legislation. I hope that we don't, in a rush to do something—that we do something that would be bad for the economy and bad for the free enterprise system, bad for the oil industry if that is the industry we are looking at.

Previous proposals that, Senator Long, you might remember, would have prohibited any oil company from merging. If they didn't merge and take over 5 percent, they were going to lose their rights to have any Federal leases, and drilling, and so on. I think that was poorly crafted legislation. I don't necessarily disagree with the intent, but I really have a problem with the legislation.

This committee is looking at several things that I think should be looked at, and hopefully maybe we will be able to come up with a positive remedy.

Deductibility of interest? This committee in connection with tax reform is going to be looking at whether or not we should deny the deductibility of interest on second homes. Well, certainly if we are going to deny interest deductions for second homes, I think we could look at denying interest deductibility for some merger situations and possible takeovers.

How do you define hostile? It is a lot easier said than done. And I look forward to working with the committee in seeing if something can't be done.

Junk bond financing? As Senator Boren and Congressman Jones mentioned, a large majority of the takeovers are now being financed by very high-yielding but relatively unsecure junk bonds. The committee might take a look at that.

You might look at moratoriums. There are a lot of different legislative solutions. I am not sure whether or not many or all should be enacted, but I think they should be looked at. And again, I look forward to working with the committee and the other interested Congressmen and Senators to see if we can't come up with a solution that does protect the free enterprise system, but also maybe get the Government out of indirectly subsidizing some of these hostile takeovers.

I thank the chairman for his willingness to let me participate in today's hearing.

Senator CHAFEE. Well, thank you very much, Senator. I know, as I mentioned earlier, you have been deeply concerned about this, and your legislation will be helpful to us. We appreciate your taking the time to be with us.

Senator Long.

Senator LONG. Thank you very much, Senator Nickles.

Senator CHAFEE. Senator Danforth.

Senator DANFORTH. No questions.

Senator CHAFEE. Thank you.

Senator NICKLES. Thank you very much, Mr. Chairman.

Senator CHAFEE. Senator Domenici.

STATEMENT OF HON. PETE V. DOMENICI, A U.S. SENATOR FROM THE STATE OF NEW MEXICO

Senator DOMENICI. Thank you very much, Mr. Chairman.

Senator CHAFEE. We welcome you here. You are a very busy man.

Senator **Domenici**. I am delighted to be here. I know that you have a litany of witnesses who know a lot more about this than I do. They will answer many more of your questions. Frankly, my concern in this area is relatively new. A year or a year and a half ago I wasn't so concerned. I thought I might come and just for 5 or 6 minutes share my thoughts.

I think you already know from what you have heard and from the general feeling that it is imperative that this committee do what it is doing. Something is wrong. We have to address this issue in some way.

I, like all of you, have been reading about junk bonds, wolf packs, poison pills, greenmail. I have also read the assessments of this new round of takeovers that vary from the claim that it is a long-needed shakeup of the stodgy corporate management, to the apocalyptic vision, that the raiders are planting the seeds of a new financial disaster that will match the tulip mania of Holland in the 16th century or the crash of 1929.

Well, regrettably, I find myself without a crystal ball in these matters; however, I must admit that originally I found the claim of market efficiency persuasive. However, I believe that the cumulative experience of the past 2 years, particularly in the energy field where I have a legislative concern, has yielded enough legitimate concerns that congressional action with all its admitted inefficiencies is appropriate.

Perhaps I have become more interested because anything that smells of a lot of debt attracts my attention, since I think our country finds itself in a mess with exceptionally high debt. I have come to the judgment on this because I am struck with the similarity of these highly leveraged mergers in the energy industry with our Nation's budget dilemma.

Senator **Chafee**. That's what we call the Puritan ethic.

Senator **Domenici**. That's correct.

Senator **Chafee**. Concern about debt.

Senator **Domenici**. Exactly; nothing better than that, Senator, and nothing more appropriate.

But in both cases it seems to me we are financing today's consumption by mortgaging the future. In both cases I believe that sound public policy requires a long-term review. For this reason the committee is to be commended for holding the hearing. It is also the reason that tomorrow I will introduce legislation calling for a moratorium on using junk bonds for the remainder of 1985. It would preclude any financial institutions where deposits are federally insured from purchasing additional amounts of these bonds during that period.

My concern is twofold. First, I fear that the heavily leveraged takeovers in the energy industry are leading to the mortgaging of our energy future by causing a reduction in research and development, and exploration and production expenditures by the acquired companies. They are going to change their pattern of behavior because they have a new phenomenon within their accounts—that is, an enormous debt that they have acquired—all in the name, as some would say, of helping the stockholders.

Second, the rapid increase in the use of junk bonds as a tool in such takeovers poses, from what I can tell, an unjustified risk to the federally insured lending institutions and I might say perhaps even to the Nation's financial system as a whole.

So prior to turning to any specifics that I have concern about, I would like to address what I consider to be the threshold philosophical argument that any congressional action is somehow tampering with the purity of the marketplace. I believe that this contention should be given short and expeditious shrift.

All markets are conducted within the constraints of a set of governmental rules. They now deal within a deregulated banking industry. Three years ago it was not so deregulated. Corporations are in fact Government creatures that are granted extraordinary powers in order to benefit all of us. The present round of mergers are being conducted within the framework of a complex set of Government regulations at both the State and Federal level. State and federally charted financial institutions that have their deposits insured by the Federal Government are deeply involved in these takeovers. So we are not engaged in a theoretical exercise as to whether we should have markets or whether such markets should have Government-imposed rules. Instead, we are faced with the more practical question of whether a rule change under which such markets operate is appropriate. Obviously, I feel that such is the case.

At this point we must look at the cumulative experience of the past year and a half. It is easy to be distracted by the most recent contest involving MESA and Unocal, but it is perhaps more instructive to look backward into the wake of these past takeover contests and examine what is happening to Gulf and Phillips. Regrettably, when we look backward our worst fears are realized. Gulf Oil, bought by Chevron, has recently closed its Pittsburgh research facilities. Phillips, which incurred massive debt in its takeover battles, has laid off research personnel, cut its capital research efforts. Research into alternative fuel sources at both companies has been virtually eliminated. Phillips' research efforts into robotics has ended. And both, along with other merged companies, have withdrawn research grants from MIT, University of Texas, Stanford, Columbia, Colorado School of Mines, University of Wyoming, and the list goes on. The question that comes immediately to mind is what will happen to the $125 million a year that Unocal spends on research and development when the siege on its corporate structure is over and when it's left with a huge debt, all in the name of stockholders.

The impact on the exploration and development budgets of the merged companies parallels that of their research budgets. Chevron's exploration and production budget is down $250 million. Phillips' is down a staggering 30 percent, $260 million. Drilling is being postponed in Alaska, the Gulf of Mexico, and overseas from China to Kenya. The exploration and drilling programs of other companies are also being affected, because many of these projects are joint ventures from which Chevron and Phillips and others are withdrawing.

The irony of this tale is that it only reinforces the argument of one school of corporate critics who claim that America is losing in the international marketplace because its corporate management has adopted too shortsighted a view and ignored long-range research and development projects. These critics claim American managers lack the patience and resolve to prevail in the long haul—all of this criticism coming at a time when we are seeing this new kind of raid which forces corporations to end up in merged postures, either forced or otherwise, with huge internal debt that they didn't have otherwise.

For those who say all of this is being done in the name of stockholders, I would ask how many people are genuinely interested in buying Phillips stock today. You might ask those who follow me, who will predicate this entire premise on stockholders and the need to protect them, and that these mergers are all in the name of stockholders.

At this point one must make a policy judgment. Should one support sacrificing the Nation's long-term energy policy through the present round of debt-financed mergers in the energy industry? For me, the answer is "No." I don't know all of the specifics, and I share the concern of those Members of Congress who preceded me as to what is the exact precise way to do it. But when one-half of the Nation's imported oil comes from an area of the world where men are killing each other with reckless abandon, I believe that all of us have a stake in continuing to explore for more oil and in looking for alternative sources of energy. I am not sure we should sacrifice this all in the name of the kind of takeovers we are witnessing, which end up with a corporate entity that remains, having paid off enormous bills and perhaps paid some stockholders additional amounts of money, but the result is a huge corporate debt. That is saying nothing about who holds those debts, including many insured institutions, insured by the people of this country.

Those who forget the past are destined to relive it, and I believe the odds are high enough that we will suffer further disruptions in supply from the Middle East over the next decade that the short-term view imposed by the oil industry and by their needs to meet the increased debt obligations will be considered, in hindsight of history, as a grave mistake.

In 1979, only $250 million of these bonds were issued. In 1984, over $14 billion were issued. In addition to a market increased in volume, there is also a change in who is issuing the junk bonds. Rather than established corporations, most of the junk bonds being issued in conjunction with takeovers are being issued by dummy corporations that end up being merged, and the new entity carries the debt of the dummy corporation with it. This new generation of junk bonds has never stood the test of an economic downturn. The recent default of Sharon Steel on its last two payments on $426 million of these bonds is a good reminder of their risk—all of this in reasonably good economic times.

Recently the Federal Reserve and the Federal Home Loan Bank Board have been issuing words of caution to federally insured institutions about the risk of these bonds.

The second factor is that if unchecked, junk bonds may continue their dramatic growth. In 1984 there were 2,800 mergers. The top 14 of these involved over $50 billion. The sky is the limit for these kinds of bonds unless we take a good hard look at whether they are good for the long-term future of this country and whether they are there to really benefit corporate entities of this country and their stockholders or a select few who have found a way to use the system to the disadvantage of all but themselves.

Obviously, in light of the risk that we are running with our energy future and our financial institutions—and you all know how difficult the job of the Federal Reserve Chairman has been in the last 2½ or 3 years, as he goes through uncharted waters with reference to the financial institutions and the risks that are now imposed upon it by heavy debt from risky debtors.

I am a cosponsor of both Senator Chafee's and Senator Boren's legislation that is pending before this committee, and I stand ready to move as quickly as you do. Tomorrow I will introduce a bill which would tell the Congress that we ought to stop, look, and listen, at least for 8 or 9 months, and put a stop to this kind of activity while this committee and others have a chance to take a good hard look.

Thank you very much, Mr. Chairman and members of the committee, for listening this morning. I am sorry I went so long, but I have just recently begun to learn this, and I felt very strongly that I ought to at least get my views out.

Thank you very much.

Senator CHAFEE. Well, thank you very much, Senator Domenici. We appreciate your coming.

Any questions, Senator Long?

Senator LONG. Yes; I would like to ask a question.

How would you define "junk bonds"? There seems to be a real problem of definition.

Senator DOMENICI. Yes, Senator, I am just finishing up my legislation with as many experts as I can put together, and I should have that language within the next 10 or 12 hours, and I would be pleased to submit it to this committee. It is obviously imperative for you, and it is imperative for my moratorium. And I concur with Senator Nickles: We don't want to make this broader than it has to be, and clearly that is difficult. But I think it can be done.

Senator LONG. Let me pose another question.

Mr. Turner is trying to buy control of CBS.

Senator DOMENICI. So I understand.

Senator LONG. That is getting more publicity than this hearing. Mr. Turner has made an offer that includes some bonds that are referred to by many as "junk bonds." However, under existing law, it would be those CBS shareholders, whose stock he is trying to buy, who will pass judgment on whether those bonds are valuable or not valuable, would it not? The individual shareholders will make the decision on whether to take Mr. Turner's offer.

Senator DOMENICI. Well, I assume that is correct, Senator.

Senator LONG. In some cases you have institutional buyers which hold large amounts of stock; but there are still investors who will look at the security offered.

My question is, how can we exercise better judgment than that market in deciding whether such bonds are good?

Senator DOMENICI. Well, let me just say to you as I did a minute ago that I have a general feeling that there is something unusual about these bonds. They really have no basic security at the beginning and have very high interest rates. They are being issued some kind of Shell Corp. for the sole purpose of making an offer to stockholders, sufficient to get control of a corporation. At that point in time, clearly, stockholders are interested in what price they will get. If they are going to get more than the present market, obviously your thesis is right, that it is a good deal.

I think we have to end up by looking at the financing mechanism behind these transactions. Who is holding these bonds? In many instances it is federally insured financial institutions. They get all kinds of benefits from the Federal Government, those bondholders who are putting money into those dummy corporations. They sell it to other S&L's and banks chartered by the Federal Government and by States, some of which are insured by depositors and some are not, and we have to take a look and find out whether or not that is an extremely risky situation, and an inordinate risk for the sole purpose of taking over companies.

Now, clearly, we can wait and let it all happen, Senator. And I didn't do any of this based on CBS; my whole concern is energy. I am firmly convinced that the entire nature of research and development and exploration by the energy companies of America is going to be changed by the debt that they are going to acquire when these mergers occurs. I don't know that that is good for America.

There are a couple of experts that I trust immensely who are in the midst of writing major papers saying that in 5 to 10 years this country will see the negative effect of this added debt to companies that were doing exploration. It is predicted that these companies are not going to be able to do it because of one single reason, they are paying off the debt, which is this very, very high interest rate in many cases of these junk bonds. They are paying that off, and they can't use their money elsewhere.

So I think we can find a way to describe it and define it without doing an injustice to the reasonable relationship between putting money up to buy stock and putting assets up to merge. And I think it can be done. I thank you for the question.

Senator **CHAFEE**. Senator Danforth.

Senator **DANFORTH**. No questions, Mr. Chairman.

Senator **DOMENICI**. Thank you very much.

Senator **CHAFEE**. Thank you very much, Senator Domenici.

[Senator Domenici's written statement along with his definition of "junk bonds" follows:]

STATEMENT OF PETE V. DOMENICI

Before Senate Finance Committee

Subcommittee on Taxation and Debt Management

April 22, 1985

I would like to open by commending my colleagues on the Finance Committee for holding this hearing on the issue of the recent surge of takeovers, especially those where the resulting corporate entity finds itself required to service large amounts of new debt.

I, like all of you, have been reading about "junk bonds", "wolfpacks", and "poison pills". I have also read assessments of this new round of takeovers that vary from the claim that this is a long needed shake-up of stodgy corporate management to apocalyptic visions that the raiders are planting the seeds of a new financial disaster that will match the tulip mania of Holland in the sixteenth century or the crash of 1929.

Regrettably, I find myself without a crystal ball in these matters. Moreover, I must admit that originally I found the claims of market efficiency persuasive. However, I believe that the cumulative experience of the past two years, particularly in the energy industry, has yielded enough legitimate concerns that Congressional action, with all its admitted inefficiency, is now appropriate.

For this reason, the Committee is to be commended for holding this hearing. It is also the reason that tomorrow I will introduce legislation calling for a moratorium on hostile takeovers using "junk bonds" for the remainder of 1985. The legislation would also preclude any financial institution where deposits are federally insured from purchasing additional amounts of these bonds during the moratorium period.

My concerns are twofold. First, I fear that the heavily leveraged takeovers in the energy industry are leading to the mortgaging of our energy future by causing a reduction in research and development and exploration and production expenditures by the acquired companies. Second, the rapid increase in the use of junk bonds as a tool in such takeovers poses an unjustified risk to federally insured lending institutions, and perhaps to the nation's financial system as a whole.

Prior to turning the specifics of my concerns, I would like to address the threshold argument that Congressional action is somehow tampering with the purity of the marketplace. I believe that this contention should be given short shrift. All markets are conducted within the constraints of a set of governmental rules. Corporations are in fact government chartered creatures that are granted extraordinary powers in order to benefit all of us. The present round of mergers are being conducted within the framework of a complex set of government regulations at both the state and federal level. In addition, state and federally chartered financial institutions that have their deposits insured by the federal government are deeply involved in these takeovers. We are not engaged in a theoretical exercise whether we should have markets or whether such markets should have government imposed rules. Instead, we are faced with the more practical question of whether a rule change under which such markets operate is appropriate.

1. The Energy Industry: Mortgaging the Future

With this argument out of the way, let me now turn to the first of my concerns, the growing use of almost exclusive debt financing for takeovers in the energy industry.

At this point, a critical distinction is in order. When a public or private entity borrows to build a project, be it an oil well, a mine, or a toll-road, it does so to create an economic activity that will generate a revenue stream that will help pay off the debt. And in the case of private companies, there is the expectation of generating a profit.

Using debt to buy a controlling block of stock in a company has a different effect. The debt is used to buy out existing stockholders at a price higher than the market had originally put on their stock. Thus the equity of the shareholders is removed and the debt of the purchaser substituted. The crucial point is that the company now has a significant increase in its debt load but no new income producing asset such as more oil wells to help service the debt. In favorable circumstances, the company will have enough existing cash flow to service the new debt. The more likely result however, is that some combination of laying off personnel, selling assets, and cancelling projects will be needed to service the new debt. And the most likely candidates for cancellation will be efforts such as research or exploration which have the most distant payoffs.

The foregoing is not strongly disputed. The dispute is not over whether this happens, but whether it is good or bad. Supporters of using large quantities of debt point to the immediate benefits to the stockholders and go on to state that the takeover process acts as a spur to management to become more efficient. However, even supporters of these takeovers do not seriously argue that the acquired corporation can achieve such efficiencies without reducing its present and projected operations.

At this point, we must begin to look at the cumulative experience of the past year and a half. It is easy to be distracted by the most recent contest involving MESA and UNOCAL.

But it is perhaps more instructive to look backwards into the wake of past takeover contests and examine what is happening to Gulf and Phillips. Regrettably, when we look backwards our worst fears are being realized. Gulf Oil, bought by Chevron, has recently closed its Pittsburgh research facility. Phillips, which incurred massive debt in its takeover battles, has laid off research personnel and cut its capital research effort by 75%. Research into alternative fuel sources at both companies has been virtually eliminated. Phillips' research efforts into robotics has ended. And both, along with other merged companies, have withdrawn research grants from MIT, the University of Texas, Stanford, Columbia, the Colorado School of Mines, the University of Wyoming and the University of Southern California. The question that comes immediately to mind is what will happen to the one hundred and twenty-five million dollars a year that UNOCAL spends on research and development when the siege on its corporate structure is over.

The impact on the exploration and development budgets of the merged companies parallels that of their research budgets. Chevron's exploration and production budget is down $250 million. Phillips' E and P is down a staggering 30%, or $260 million. Drilling is being postponed in Alaska, the Gulf of Mexico, and overseas from China to Kenya. The exploration and drilling programs of other companies are also being affected because many of these projects are joint ventures from which Chevron and Phillips are withdrawing.

The irony of this tale is that it only reinforces the arguments of another school of corporate critics who claim that America is losing in the international marketplace because its corporate management has adopted too short sighted a view and ignored long range research and development projects. These critics claim American managers lack the patience and resolve needed to prevail over the long-haul. Experience in the energy industry is demonstrating that buying out present stockholders with debt exacerbates this short sighted trend as long range projects are curtailed to meet the more immediate problem of servicing the new debt.

At this point, one must make a policy judgment. Should one support sacrificing the nation's long term energy policy through the present round of debt financed mergers in the energy industry? For me, the answer is no. When half of this nation's imported oil still comes from an area of the world where men are killing each other with reckless abandon, I believe that all of us have a stake in continuing to explore for more oil and in looking for alternative sources of energy. This becomes even more important in light of Department of Energy projections show our imports doubling over the next decade. The philosopher Santayana said that those who forget the past are destined to relive it. I believe the odds are high enough that we will suffer further disruptions in supply from the Middle East over the next decade that the short-term view imposed by the oil industry's need to meet its increased debt obligations will be considered, in the hindsight of history, a grave mistake.

In coming to this judgment I am struck by the similarity of these highly leveraged mergers in the energy industry with our nation's budget dilemma. In both cases we are financing today's consumption by mortgaging the future. In both cases, I believe sound public policy requires a longer-term view.

2. Junk Bonds: The New Financial Opiate

Junk bonds are by definition higher yield, higher risk bonds than those to be considered to "investment grade." Their higher yields greatly exacerbate the debt load of the surviving corporation. Several percentage points on billions of dollars of loans means that the surviving corporation must contract itself even further, increasing the short-run view of management. The higher yields also mean that the company and bondholder are exposed to greater risks during an economic downturn when cash flow declines. A more fundamental problem is that S and L's and pension funds purchasing these bonds are insured by the federal government. To the extent that sophisticated investors want to take risks with such bonds, then that is their choice. To the extent the federal government is liable, then we clearly have a different problem. I can think of no reason that the taxpayer should shoulder any of the risk of these speculative bonds.

I recognize that you will hear some impassioned defenses of merits of these bonds. You will be told that they have proven to be excellent investments and that their high yields have more than compensated for their failure rate. It is important, however, to recognize that the experience of the markets with these bonds is very slim. In 1979, only 250 million dollars of these bonds were issued. In 1984 over 14 billion dollars of these bonds were issued. In addition to a marked increase in volume, there has also been a change in who is issuing junk bonds. Rather than established corporations, most of junk bonds being issued in conjunction with corporate takeovers are being issued by dummy corporations. This new generation of junk bonds has never stood the test of an economic downturn. The recent default of Sharon Steel on its last two payments on $426 million of these bonds is a good reminder of their risk. Recently, the Federal Reserve and the Federal Home Loan Bank Board have been issuing words of caution to federally insured institutions about the risks of these junk bonds.

So far I have spent my time discussing the greater risks that individual target companies and individual investors run by engaging in leveraged buyouts with junk bonds. To assess the total risk to our financial institutions two other considerations must be factored in. The first is the simple recognition that over the past 5 years the Federal Reserve has been navigating through a financial mine field that appears to be without end. The debt of the lesser developed countries remains poised to erupt again during the next worldwide recession. The Savings and Loans in this country continue to go bankrupt at an alarming rate. And we are being treated to a steady diet of other failures, the recent Ohio banking emergency being the most dramatic. The second factor is that if unchecked, junk bonds may continue their dramatic growth. In 1984 there were 2800 mergers. The top 14 of these involved over $50 billion. The sky is the limit for junk bonds unless we stop and ask ourselves whether our presently fragile financial institutions can stand the risks associated with a vast increase in the amount of high risk, high yield bonds in our capital markets.

The complexity of these problems argues for a cautious approach. However, I believe we must do better than the usual Congressionally mandated study. Whenever I hear of these studies I am reminded of Justice Goldberg's remark that if Columbus had

had an advisory committee, he would still be at the dock. In light of the magnitude of the risks we are running with our energy future and our financial institutions, I believe that a moratorium is in order. However, if the Congress is ready for stronger action, I am ready. I am a cosponsor of both Senator Chaffee's and Senator Boren's legislation that are pending before this committee, and if you wish to take a stronger dose of medicine to the Senate floor, I stand ready to support you.

Senator CHAFEE. Our next witness is a long-time friend of all of us, former Senator Nick Brady.

We are delighted you are here, Senator Brady, and in the course of your testimony maybe you can answer the question that Senator Long asked, and that is the one we all are wondering about: How can you tell a "junk bond"?

But I don't want to interrupt your testimony. Maybe you could bring that out in the course of your testimony, or else we will reserve it for a question when you are through. Why don't you proceed as you wish?

STATEMENT OF HON. NICHOLAS F. BRADY, FORMER U.S. SENATOR, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, DILLON, READ & CO., INC., NEW YORK, NY

Mr. BRADY. Thank you, Mr. Chairman. If it is OK with you, I have a prepared statement which I will submit for the record and merely summarize my remarks.

Senator CHAFEE. That's fine.

Mr. BRADY. Mr. Chairman, Senator Long, Senator Danforth, Senator Pryor, my name is Nicholas Brady. I am chairman of the New York investment banking firm of Dillon, Read & Co. Our clients include a broad spectrum of American businesses, among them the Unocal Corp. I applaud the willingness of the members of the Senate Finance Committee, and particularly the chairman of this subcommittee and Senator Boren, to confront the difficult problem of junk bond takeover financing.

I should say at the outset that, aside from my time in public office, I have spent my entire working life in the business world and specifically in the financial markets. I believe strongly in the free market, in the protection of shareholders' rights and in the exercise of shareholder democracy—which includes the rights of shareholders to rid themselves of slow-moving entrenched management when they desire to do so. But I cannot stand idly by as this speculative frenzy increasingly endangers our savings institutions and our system of corporate enterprise.

The system we have developed in this country for financing private sector activity ultimately rests on the confidence of the public in the integrity of financial markets. Whenever this integrity is threatened, as it is now, the appropriate response must be weighed carefully but implemented promptly.

By imposing an immediate moratorium on the use of junk bonds to finance hostile tender offers, Congress can dampen the speculative fever that the takeover craze has engendered among our savings institutions and slow the alarming trend toward the over-leveraging of American corporations. Congress then would have the time to develop a careful rifle-shot approach to the problem.

What is happening now is similar in some respects to the speculative abuses of Sam Insull and others which led to the 1929 crash. It is also similar to the more recent "Chinese wallpaper" craze of the late 1960's which flooded the financial scene with poorly conceived takeovers financed by convertible debentures. At that time, as I am now, I came to Washington to urge corrective action.

Many of my colleagues on Wall Street and indeed my own firm earn significant profits from the current speculative activity, and it may be in our own self-interest to look the other way. We should not. Many of us feel it is our overriding responsibility to bring to your attention this dangerous trend affecting our financial system. Speculative, highly-leveraged financing techniques involving junk bond takeovers, if unchecked, will leave misery in its wake.

As you know, junk bonds—essentially high risk, high yield, less than investment grade debt—have been around for some time. What is new and dangerous is the rapidly expanding use of junk securities to finance leveraged hostile acquisitions. These "junk takeover bonds" are most often in the form of unregistered, unrated or low-rated debt or quasi-debt securities. The bonds entail substantial risks to investors, risks which in many cases have not been and indeed cannot be adequately assessed.

Why, then, do raiders, insurance companies, foreign banks, pension funds, S&L holding companies and a nationwide church join a junk takeover bond syndicate? The answer? Substantial commitment fees, very high interest rates, and the right to share in greenmail profits in many cases. The purchasers can also compel the target company—which once it is acquired must assume the debt—to register the junk bonds for sale in the secondary market, thereby trying to make sure that they can remarket such bonds as quickly as possible, leaving others to bear the long-term risks.

An avalanche of hostile takeover financings using junk bonds continues to roll through the market, and I think Senator Nickles and all of you are familiar with the number that are going on—not only the $3 billion for Unocal, $400 million for Crown Zellerbach, $600 million for ANR by the Coastal Corp., $5.4 billion for Turner and CBS, but the list goes on and on, and I am sure there are many more in the hopper and underway right now, being conceived.

I am concerned that the use of junk bond takeover financing represents a dangerous destabilizing element for our national savings system, an element which, I might add, is largely dedicated to unproductive purposes. Thrift institutions, pension funds, insurance companies, and at least one church are buying these highly leveraged, unrated, speculative investments. We have seen what has happened when these and similar institutions reach for higher yields without regard to security or safety or the soundness of principal.

Now, I have always believed that the purpose of our national savings system is to finance real growth in this country and thus create new jobs for the American people and serve consumers by producing goods at the lowest possible price. For the life of me, I cannot see how this current junk takeover frenzy anywhere fits into this definition. In fact, quite the opposite is true. Be it Unocal, Uniroyal, Crown Zellerbach, or Hilton Hotels, the financing arrangements connected with these takeovers mandate the opposite result.

Some will argue that as an economic matter we ought not to be concerned with the use of junk takeover bonds. By the time all the testimony has been presented, you will have heard a lot about macroeconomics and the argument that all is well because the money paid to Unocal shareholders for their stock will wind up invested elsewhere in the system.

Unfortunately, we live in a microeconomic world, one in which Government policymakers will have to deal with lost jobs, higher energy prices, increased pressure on interest rates, not to mention potential failures of thrift institutions and losses to pension funds and other purchasers of junk takeover bonds.

Dealing with junk takeover bonds requires a comprehensive policy approach. That is why I favor an immediate moratorium so that we can then move cautiously over the next several months to develop the best comprehensive solution.

There are many agencies involved who should be concerned with this problem—the Federal Home Loan Bank, the Federal Reserve Board, the Securities and Exchange Commission, the Treasury Department, the Department of Labor, and the Pension Benefit Guarantee Corporation.

The proposed legislation you are considering today represents the view that junk bond takeovers should be halted by amending the Tax Code, and I commend your efforts. A moratorium on junk takeover bonds would complement this work while tax experts make certain that we are not devising a solution that might create more problems than it will solve.

It may very well be that the use of junk takeover bonds is viewed in some quarters as a means to get at the problems of corporate governance. But questionable and potentially damaging financing maneuvers are just not appropriate ways to challenge management. There are less dangerous and more direct methods to enhance stockholders' rights and deal with the problem of entrenchment.

Let me end my statement where I began. I believe firmly in the operation of free and efficient markets, but we have reached a moment of excess. I also believe in the use of automobiles and their great utility to this society. Yet, society has determined that drunk driving and driving at excess speeds cannot be allowed. And when no less than eight major hostile junk takeovers are in the process at this very moment, including at least $10 billion in junk financing, there is a great deal of drunk driving and speeding going on.

Thank you very much.

[Mr. Brady's written statement follows:]

STATEMENT OF
NICHOLAS F. BRADY
CHAIRMAN
DILLON, READ & CO. INC.
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE
April 22, 1985

Mr. Chairman and Members of the Subcommittee:

My name is Nicholas Brady. I am Chairman of the New York investment banking firm of Dillon, Read & Co. Inc. Our clients include a broad spectrum of American businesses, among them Unocal Corporation. I am pleased to appear before you today to discuss an unprecedented wave of takeover activity, and to express my deep concern with the growing use of so-called junk takeover bonds and similar highly leveraged, high-risk instruments to finance unproductive corporate raids. I applaud the willingness of members of the Senate Finance Committee, and particularly the chairman of this Subcommittee and Senator Boren, to confront this difficult problem. I urge you to continue your efforts apace.

I should say at the outset that, aside from my time in public office, I have spent my entire working life in the business world and specifically in the financial markets. I believe strongly in the free market, in the protection of shareholders' rights, and in the exercise of shareholder democracy -- which includes the rights of shareholders to rid themselves of slow-moving, entrenched management when they desire to do so. I am not opposed to takeovers, hostile or friendly. But I cannot stand idly by as this speculative frenzy increasingly endangers our savings institutions and our system of corporate enterprise.

The system we have developed in this country for financing private sector activity ultimately rests on the confidence of the public in the integrity of the financial markets. Whenever that integrity is threatened, as it is now, the appropriate response must be weighed carefully, but implemented promptly.

By imposing an immediate moratorium on the use of junk bonds to finance hostile tender offers, Congress can dampen the speculative fever that the takeover craze has engendered among our savings institutions, and slow the alarming trend toward the over-leveraging of American corporations. Congress then would have time to develop a careful rifle-shot approach to the problem.

What is happening now is similar in some respects to the speculative abuses of Sam Insull and others which led up to the 1929 crash. It is also similar to the more recent "Chinese Wallpaper" craze of the late 1960's which flooded the financial scene with poorly conceived takeovers financed by convertible debentures. At that time, as I am doing now, I came to Washington to urge corrective action.

Many of my colleagues on Wall Street and, indeed, my own firm, earn significant profits from the current speculative activity, and it may be in our own self-interest to look the other way. We should not. Many of us feel that it is our overriding responsibility to bring to your attention this dangerous trend affecting our financial system. And I believe we are considering today one of the most threatening abuses of our system I have witnessed in my 30-year career. Speculative, highly leveraged financing techniques involving junk takeover bonds, if unchecked, will leave misery in their wake.

As you know, junk bonds -- essentially high risk, high yield, less than investment grade debt -- have been around for some time. What is new, and dangerous, is the rapidly expanding use of junk securities to finance leveraged hostile acquisitions. Those "junk takeover bonds" are most often in the form of unregistered, unrated (or low rated) debt or quasi-debt securities. In most instances, these instruments are issued by a shell corporation that has been created as the vehicle for a hostile takeover attempt. These bonds entail substantial risks to investors, risks which in many cases have not been, and indeed cannot be, adequately assessed.

Why, then, do many raiders, insurance companies, foreign banks, pension funds, S&L holding companies and a nationwide church join a junk takeover bond syndicate? The answer -- substantial commitment fees, very high interest rates and the right to share in "greenmail" profits in many cases. The purchasers also can compel the target company -- which once it is acquired must assume the debt -- to register the junk bonds for sale in the secondary market, thereby trying to make sure that they can remarket such bonds as quickly as possible.

Junk takeover bonds only very recently appeared on the corporate scene as a mechanism for giving corporate raiders access to funds over and above their own cash and conventional bank credit. In order for a corporate raider to initiate a leveraged hostile acquisition -- or to set the stage for greenmail -- an exceptionally large pool of funds must be assembled; this is typically accomplished with a combination of bank credit and junk bonds. The economic dynamics are such that in the vast majority of cases neither the bank credit nor the junk bonds are funded on a permanent basis.

The stock of the target company is ordinarily purchased for cash financed with enormous leverage consisting of bank debt and junk bonds. In addition, the second step or "back end" of the takeover usually necessitates issuance by the target (or raider) of debt securities, which results in the piling on of a great deal more debt. This imprudent debt binge creates an absolute mandate to lay off people and sell assets. Let me be clear. The most likely result of the raider's quest for "enhanced stock values" is the "bust up" of the target.

An avalanche of hostile takeover financings using junk bonds continues to roll through the markets. It appears that there is a rush on Wall Street to push as much money as possible through the junk bond window before the Federal government catches on to its perils. Consider the following list of current takeover bids that were commenced on a hostile basis in the last few months and are being financed in whole or in part with junk takeover bonds in staggering amounts:

- $3 billion in junk takeover securities for Mesa Partners II to take over Unocal Corporation.
- $400 million in junk takeover securities for Sir James Goldsmith to take over Crown Zellerbach.
- $600 million in junk takeover securities for Coastal Corporation to take over ANR Co.
- $395 million in junk takeover securities for Triangle Industries to take over National Can Corp.
- $5.4 billion in junk takeover securities for Turner Broadcasting to take over CBS.

- $275 million for Carl Icahn to take over Uniroyal (partially financed by junk takeover securities).
- $1.78 billion for Golden Nugget Inc. to take over Hilton Hotels Corp. (partially financed by junk takeover securities).
- $1.02 billion for Lorimar to take over Multimedia, Inc. (partially financed by junk takeover securities).

I am concerned that the use of junk takeover bond financing represents a dangerous destabilizing element for our national savings system, an element which, I might add, is largely dedicated to unproductive purposes. Thrift institutions, pension funds, insurance companies and at least one church are buying these highly leveraged, unrated, speculative instruments. We have seen what has happened when these and similar institutions reach for higher yields without regard to security or safety or the soundness of principal.

I have always believed that the purpose of our national savings system is to finance real growth in this country and thus create new jobs for the American people and serve consumers by producing goods at the lowest possible price. I cannot see how this current junk takeover frenzy fits into this definition. In fact, quite the opposite is true. Be it Unocal, Uniroyal, Crown Zellerbach, or Hilton

Hotels, the financing arrangements connected with these takeovers mandate the opposite result.

Let us focus for a moment on the result a junk bond-financed takeover would have in Unocal's case. I have attached a chart to my statement which illustrates the Company's debt structure both before and after the proposed Mesa takeover, if it were to be carried to completion. As you can see, the surviving corporation is so heavily burdened with high-cost debt that its future operations must be severely impaired, if not endangered.

The second chart summarizes the proposed financing structure of the Unocal transaction and its impact on the corporation's constituencies. There can be no other result if this transaction is completed than lost jobs at Unocal and its suppliers. Equally troubling is the reduction in exploration for new oil (Unocal presently has one of the lowest finding costs of the major oil companies) and in the development of alternative energy sources.

Some will argue that as an economic matter, we ought not to be concerned with the use of junk takeover bonds. By the time all the testimony has been presented, you will have heard a lot about macroeconomics and the argument that all is well because the money paid to Unocal shareholders for their stock will wind up invested elsewhere in the system.

Unfortunately, we live in a microeconomic world -- one in which government policymakers will have to deal with lost jobs, higher energy prices, increased pressure on interest rates, not to mention potential failures of thrift institutions and losses to pension funds and other purchasers of junk takeover bonds who are not properly equipped to acquire the risks associated with these instruments either in the primary or secondary markets.

I believe it is hazardous to evaluate junk takeover bonds solely on a macroeconomic basis. I am not convinced that the savings in existence at the front end of the junk bond process will soon be productively redeployed. Clearly in the short run, a good portion of these savings may be diverted to finance yet another takeover attempt.

Dealing with junk takeover bonds requires a comprehensive policy approach. That is why I favor an immediate moratorium so we then can move cautiously over the next several months to develop the best comprehensive solution. For example, the Federal Home Loan Bank Board should be concerned about investment activities of thrift institutions and the adequacy of the insurance fund backing its deposits, while the Federal Reserve Board should review the increase in leverage and the reduction in equity of our corporations, and abuses of margin requirements. The Securities and Exchange Commission, in maintaining the integrity of the takeover and the securities underwriting processes, should continue to make certain that the markets are not being manipulated. The Treasury should consider the application of the debt/equity rules of the Internal Revenue Code to junk takeover securities. And the Department of Labor and the Pension Benefit Guaranty Corporation should be concerned about the safety of pension funds that invest in junk takeover bonds.

Finally, the Senate Finance and House Ways and Means Committees are justifiably concerned with whether our existing federal income tax system promotes excessive leveraging in connection with merger and acquisition activity. The proposed legislation you are considering today represents the view that junk bond takeovers should be halted by amending the tax code. A moratorium on junk takeover bonds would complement your efforts, while tax experts make certain that we are not devising a solution that might create more problems than it will solve. I have found from my experience in the financial markets that the ingenuity of the private sector is unlimited. If we legislate in haste, we may repent at leisure. What we really need is a comprehensive approach to the problem.

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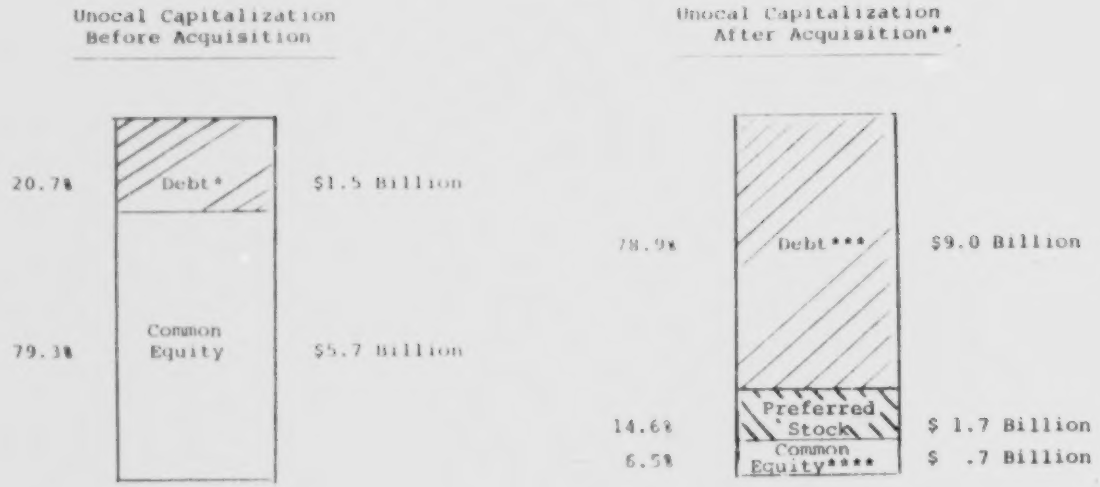
It may very well be that the use of junk takeover bonds is viewed in some quarters as a means to get at problems of corporate governance. But questionable and potentially damaging financing maneuvers are just not appropriate ways to challenge management. There are less dangerous and more direct methods to enhance shareholders' rights and deal with problems of entrenched management.

Let me end my statement where I began. I believe firmly in the operation of free and efficient markets, but we have reached a moment of excess. I also believe in the use of automobiles and their great utility to society. Yet society has determined that drunk driving and driving at excess speeds cannot be allowed. And when no less than eight major hostile junk takeovers are in process at this very moment, including at least $10 billion in junk financing, there is a great deal of drunk driving and speeding going on.

Thank you.

EFFECT ON UNOCAL CORPORATION'S CAPITAL STRUCTURE OF ACQUISITION BY MESA PETROLEUM CO.



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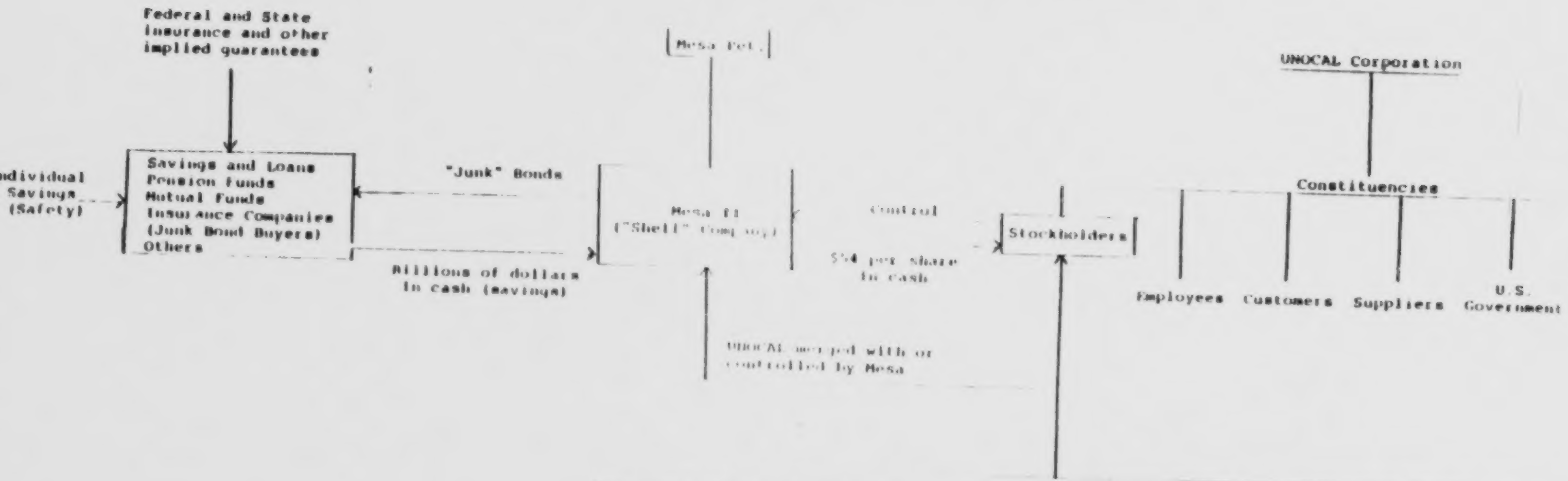
* Debt includes capital lease obligations.

** Assumes that "back end" shareholders will receive two-thirds subordinated debt and one-third preferred stock in exchange for their shares, as in Gulf Investors Group plan.

*** Total debt less $2.5 billion, consisting of all available cash and equivalents, secured installment notes and marketable securities.

**** Assumes Mesa will exercise its right to exchange Senior Subordinated Notes for Exchangeable Preferred Stock following the merger.

HOW INDIVIDUAL SAVER INADVERTANTLY FINANCES A LOSS OF JOBS, TAX REVENUES AND PRODUCTION AS WELL AS REDUCING COMPETITION IN THE OIL INDUSTRY AND RAISING ENERGY PRICES


Federal and State
Insurance and other
implied guarantees
ndividual
Savings
(Safety)
Savings and Loans
Pension Funds
Mutual Funds
Insurance Companies
(Junk Bond Buyers)
Others
"Junk" Bonds
Billions of dollars
in cash (savings)
Mesa Pet.
Mesa II
("Shell" Company)
Control
$54 per share
in cash
UNOCAL merged with or
controlled by Mesa
Stockholders
UNOCAL Corporation
Constituencies
Employees
Customers
Suppliers
U.S.
Government

Mesa pays cash for 51% of UNOCAL and uses control to force merger and:

- Repay its "Junk" Bond financing from asset sales, layoffs and other methods
- Forces new "Junk" Bonds on remaining UNOCAL shareholders to complete merger

Effect on other UNOCAL Constituencies:

- Eliminate jobs at UNOCAL (multiplier effect)
- Eliminate jobs at suppliers servicing UNOCAL (multiplier effect)
- Less new oil exploration (UNOCAL has lowest finding cost of the major oil companies)
- Reduced oil and gas reserves
- Higher energy prices
- Higher cost of living
- Loss of tax revenue
  - •Corporate
  - •Individual
- Reduced R&D into alternative energy sources.

Senator CHAFEE. Well, thank you very much, Mr. Brady. We appreciate a great deal your testimony.

Now back to the question Senator Long raised. The Supreme Court said that you can't define pornography, but when you see it you know it. Now, junk bonds—can we define them? Are they a debt instrument? Is it an equity instrument? What is it, anyway? How do we define it?

Mr. BRADY. Senator Chafee, I think it is a difficult problem to define a junk bond, and that's why I think the moratorium is your appropriate way to go on this. It will take a lot of good lawyers and good staff to come up with the appropriate definition.

But I think when you see, in the case of Unocal, a corporation which had $6 billion of equity before this process started and $1 billion of debt, and when it gets through it is going to have $12 billion of debt and very little equity, perhaps the definition of junk bonds isn't really necessary.

What actually is described as "junk bonds" in my opinion is very close to equity, but the terms on those instruments do have debt characteristics to them. It is a very close problem that the Treasury has wrestled with for years and one in which I am sure they are very interested this morning.

Senator CHAFEE. Of course, in having the moratorium, we would have to have some kind of a definition in order to impose the moratorium. We wouldn't obviously want to stop issuance of all high-grade debt instruments during that time.

Mr. BRADY. I agree with that, and I would be very interested to see what Senator Domenici comes up with. When I was in the Senate, Senator Long gave me a lecture one day about a parish in Louisiana. He said, "Nick," he said, "you should take some advice from that parish minister." He said, "There is a big difference between preaching and meddling."

And I would leave the exact language of how this legislation should be framed to the experts. I think it is possible. I mean, we do come up with laws. We came up with laws under the Williams Act; we have come up with laws in many cases. It is a tough job, but I think it can be done.

Senator CHAFEE. Well, I think so too.

Well, we appreciate a great deal your coming down and giving us your thoughts, particularly as you mentioned that your firm or individuals in it might be profiting from this junk bond business.

Mr. BRADY. To be perfectly blunt about it, I don't want to turn this into any kind of a personal statement about our firm; but there is an enormous amount of money being made on Wall Street by defending these takeovers now. It is enormous. And if you stop it, there is going to be less. But I firmly believe we have reached a time when this ought to be looked at more carefully. This is a frenzy, and I do not think we know all of the ramifications of how this financing operates.

For instance, I do not believe we know who the final purchasers of these bonds are. We have lists submitted to us saying who the original purchasers are with rights to register. I do not believe we know where these instruments are finally winding up. I also don't believe, as I think Chairman Voelker said last year that in 1984 $60 billion was sucked out of American corporations' equity accounts and replaced by debt—I don't think that is good. And I do not think that corporations can exist with 80- or 90-percent debt ratios in industries such as the oil business where you have fluctuating oil prices. To me, you can talk about it any way you want to talk about it, it simply doesn't pass the smell test.

Senator **Chafee** You put your accent on the junk bond aspects of it rather than the dislocation to management that inevitably takes place with time and energies being devoted to defensive tactics, rather than proceeding with developments that would improve the long-range viability of their corporations. But obviously, you share those concerns.

Mr. **Brady**. Well, I do. I mean, this is the macroeconomic versus the microeconomic argument. It runs, "Don't worry about it." I mean, "All shareholders will take the money that is given to them, and it will wind back into the system in productive purposes of one kind or the other." The problem is, we don't live in the short term in that world. If this committee and Congress is willing to wait for 2 or 3 or 4 years until this scenario plays its way out, with the disasters that I see ahead of it, I am sure the American financial scene is strong enough to stand it. But my point is, why? In the meantime we are going to see an enormous amount of dislocations. In the very shortspan we are sucking money out of the system when junk bond financing is raised to pay off shareholders. And the result of that because of the high leverage involved is that you have to turn out employees, the people who are supplying the corporations that are being reduced in size, the suppliers are going to have less people employed. In the case of the oil industry, competition is going to be reduced; there are going to be less players in the game.

I don't think any one of these takeovers, be it junk or one that was made as a result of a threat of junk bonds, has increased employment. People aren't drilling for more oil on account of it.

My simple mind tells me that when less people are drilling for oil there is going to be less oil found, and energy prices are going to go up. Your argument goes, "Well, that's fine. When it gets up, then a lot of people will come in and drill again." Why let it go up? Our job is to keep the price of oil down.

Senator **Chafee**. Thank you.

Senator Long.

Senator **Long**. It is nice to see you back here today, Mr. Brady. I appreciate your statement.

Mr. **Brady**. Thank you, Senator.

Senator **Long**. I have no questions.

Senator **Chafee**. Senator Danforth.

Senator **Danforth**. We are all glad to see you back, Senator Brady, and we appreciate what you had to offer the Senate while you served here and your willingness to come back and share with us your views on a matter where you have true expertise.

If a prospective raider came to Dillon-Read and said that, "I have a corporation with net worth of x, and I want to take over a corporation with a net worth of $10x$, and I want you to help put this together for me," would you advise that person that it's risky business? Or is this something that has become such a tried and true way of getting rich that it is just found money?

Mr. **Brady**. Senator, I think these things are all a question of judgment and perspective. I think there are some takeovers that make some sense. I mean, I can't say as I have an absolute objection to an unfriendly takeover if that takeover was made with a reasonable amount of debt, 50 percent debt or 40 percent debt and the rest financed by equity money. That wouldn't bother me. Our firm particularly doesn't get into this very much. I don't happen to like them, but I see it as a very useful way to allow shareholders an option to sell if they want to. I just simply don't believe we ought to do it with highly leveraged plans that mandate. It offends me. It may be all right in the macroeconomic sense, but it offends me to think of corporations that have been in existence for 60 or 70 years being dismembered for the sake of a few bucks in the stock market.

Senator **Danforth**. What would "highly leveraged" mean to you? What would be the percentage?

Mr. **Brady**. Well, you can't say in any particular case what is high leverage and what is not. It depends on the purchase price. Now, if you pay $20 for something and it is worth $35 or something like that, you obviously have a lot more room to leverage a corporation than you do if you pay right up near the top of its value, because then, you know, you are almost making sure that your margin for error has to be very, very tight.

It really isn't any different than the deficit problem in this country. The real risk of the deficit is do we expose ourselves to risks that we aren't smart enough to know about, whether they come from overseas or whether they come from internally. And the same thing is true of a corporation—the higher you put the leverage, the less control you have over your future. At some point the guy who runs the bank is going to come in and tell you how to run your business.

Senator **Danforth**. When the people who are interested in getting involved in these takeovers do so, they go around and try to get various—what?—pension funds and so on to invest with them. Is that right? They raise the money that they need by——

Mr. **Brady**. They raise the money is raised, and the lists are submitted on record with the SEC.

Senator **Danforth**. But what I am getting at is that risky for them? I mean, let's suppose that a pension fund says that it looks good?

Mr. **Brady**. Well, I think a pension fund is perhaps different from a savings and loan. A savings and loan operates on a very think margin anyway. We all know the problems that savings and loans have been through, and in my mind it is bad public policy for the U.S. Government or State governments to be insuring savings and loans that are buying risky investments. It is just a piling on that doesn't need to exist.

We have all seen what happens when savings and loans reach for extra yield, whether it is ESM, a rebel corporation or Drysdale Securities. Whenever people go for extra yield and take on extra risks, they take the chance of being dictated to by the market. And I think in this case here there is no question in my mind that that is going on in this process. How much of it? I don't know. I think that is what this takeover period ought to be used for. I think there ought to be a complete record of how this financing is arrived at, who is buying it, who is buying it initially, whether there is any remarketing of those bonds and, if those bonds are remarketed, where they are going.

I can't give you that opinion, I don't have that information, and I don't think we have the information to make that determination at this particular point in time.

Senator DANFORTH. Do you view this as a matter that should be addressed by changing the tax laws, or do you believe it is more of a security laws issue?

Mr. BRADY. Well, the reason, Senator, why I listed the various constituencies that have a place in trying to determine the various agencies that have an interest in this particular problem is, I'm not quite sure. I am not sure we know exactly what the problem is. As I said to you earlier, it just doesn't pass the smell test with me.

When you talk about whether we should change the Tax Code, that's been done a number of times. And generally speaking, the lawyers and people who are dealing in this area are pretty clever in finding their way around it.

I have no objection to changing the Tax Code for legitimate purposes; I just think it is terribly difficult to do it that way. I mean, I think it is a commendable effort, but I think it is a very hard job to do.

Senator DANFORTH. Do you think there will be ways around any changes in the tax laws?

Mr. BRADY. It tends to happen that way. I mean, back in the end of the 1960's, changes were made because of the so-called Chinese wallpaper convertible debenture craze. And the Tax Code, as I remember it—I am not an expert on it but the Treasury officials could give it to you—I think there was a change in the Tax Code at that particular point in time, aimed specifically at stopping that kind of highly-leveraged takeover. I think it worked for a little while, and then people found their way around it. They obviously found their way around it, because that is what we are talking about today.

So I am wary about saying that you can come up with a situation which would exactly—I think you should rifle shoot this problem; I don't think this ought to be a shotgun thing. And I worry a little bit about that Tax Code change doing that. On the other hand, the idea that it is immoral or that we are tampering with the free markets when we change the Tax Code, I worry about it, but we are about to make, as Senator Nickles said, mortgages on second homes nondeductible. I mean, are we tampering with the free market when we do that? I think these arguments are used on both sides of the question quite artfully all the time.

Senator DANFORTH. Are you concerned that the problem of entrenched management, slow-moving management, might become more of a problem if we act? I think you indicated in your testimony that there are other ways of dealing with the problem of entrenched management other than these leveraged takeovers.

Mr. BRADY. Well, I think you have put your finger on a very key point. One of the reasons why I was worrying about testifying this morning is; I believe in shareholders' rights, and I don't believe in "management should be entrenched." I think where we are getting confused is between the matter of corporate governance, which may be at the bottom of some of our concerns here, and unsound financing techniques.

I think we ought to be sure we understand what is going on, and take over bond financing. And I think, at the same time, it would suit me just fine if—maybe not this committee—if we looked into the matter of corporate governance, because I am not sure that we ought to have things like "poison pills" and all the names that have finally gotten connected with this effort. It reminds me of a monopoly game instead of business.

Senator DANFORTH. Thank you.

Senator CHAFEE. Well, Senator, I want to say that I share your concern about entrenched management. And the difficulties are the defensive barriers they are setting up under some of the schemes that you mentioned.

Senator Pryor.

Senator PRYOR. Mr. Chairman, I just want to say as a member of this committee and of the Senate how glad I am that Senator Brady is back with us today. He is a very positive and constructive former colleague of ours, and I think he is one of those people who always does what he truly believes is right, and today is no exception. I want to compliment Senator Brady and thank him for his leadership and say that I, as one member of this committee, share his concern about this takeover problem. I thank our friend Senator Brady.

Thank you.

Senator CHAFEE. Thank you.

Senator Bentsen.

Senator BENTSEN. Senator Brady, that is a very well balanced statement you have made. You are a broad-gauged man, and I like that.

But I worry about entrenched management. And I have seen instances where they load themselves up with perks, they really haven't that much interest in the stockholders, and really abuse their power. They say, "If you don't like the way I run the company, just go sell your stock," and that is what the fellow usually does who is a shareholder.

On the other hand, I think some of these things have gone too far, these highly leveraged situations that we are looking at.

But to look at section 338 and to say that I was to go out and try to buy another company that I thought should have a synergistic effect, and that the shareholders of both companies would finally profit by it, and then to say if I bought it and the management opposed me, and its board of directors, and even though they are called "independent directors," most of them are really picked by the management and they feel some obligation, but the company that I acquired that they would have to pay tax on appreciation of the assets, that we would begin to tilt the tax system to try to stop those kinds of things, that also concerns me. It is going to be a very difficult thing in which to try to achieve balance.

I can recall a situation as a businessman when I wanted to go buy a company in another State, and management had lobbied the State legislature and had a law where you could not get the stockholder list. That wasn't for the protection of the stockholders; that was for the protection of that management, to keep that job so no one else could make an offer that wasn't approved by the management. And that concerns me. We just have to try to achieve a balance, and it is not going to be easy.

I think, too, that if you have the extreme leveraged bonds, junk bonds, that there is no question that there is a high risk. And when you see S&L's or somebody reach out to try to increase their yield and buy that kind of an asset, you are asking for real trouble in the country.

So, I think your testimony is helpful, and I think our job will not be easy in trying to achieve some kind of balance and avoid the pitfalls you are talking about.

This management that sets up these "poison pills" and "golden parachutes" stagger their boards and do all those types of things to frustrate any kind of an offer to their shareholders. I don't have much sympathy for that either.

So I didn't ask you any questions; I just expressed my concerns, Senator.

Mr. **BRADY**. Senator, I am very glad, with not only your vast experience in the Senate but your very successful business career, that you are focusing on this problem. And I don't disagree with the way you have set the problem up; I think it is exactly right.

Senator **CHAFEE**. Senator Boren.

Senator **BOREN**. Thank you very much, Mr. Chairman. I am sorry to report we haven't solved all of the problems yet on the Nicaraguan matter. The discussion has not gone yet. So I got to come back for a few more minutes.

I want to join the others in welcoming Senator Brady back. I appreciate very much the example of public service he continues to set—not only did he set that example in the Senate but he continues to set it as a business leader in the very best possible way.

When you talk about junk bonds, is there any way we could define that? Let's say we took the grading scale. For example, is it double-B? Is there a rating at which you would say with some certainty you finally crossed over into what you would call the "high-risk junk bond" area? How could we define that?

Mr. **BRADY**. Senator Boren, I can't tell you that I spent a long time trying to focus on the definition that is going to be vital to this committee if it goes forward. Obviously, if you increase the rating that you are talking about, if you say that you can't use anything below a triple-B bond or anything below a single-A bond, you will have an effect on the process and you will slow it down.

I think you need to think it through very carefully and very slowly. I think there is a definition that will work. I am not here this morning to tell you I have one in my own mind.

Senator **BOREN**. But is it possible that we might use the rating system as a way of defining it?

Mr. **BRADY**. I think it is a very useful idea.

Senator **BOREN**. In regard to what Senator Bentsen just said, I agree that there are a lot of things that management does that I don't approve of. There are a lot of times when management is not really looking after the shareholders' interests. And we don't want to build a fence—and I heard you say that—we don't want to build a fence around bad management.

Do you draw a distinction between an offer to buy a company, to buy all the shares, and these attempts to make different offers for different shares—either a two-tier or a multi-tier hostile takeover attempt? And the same thing with the greenmail payments. It is pretty hard to say that all the stockholders benefited in the long run because half a dozen people or one or two, or maybe just one, pocketed a rather large payment, at a much higher payment for his stock or her stock than the other shareholders get. Would that be a way of perhaps narrowing the universe of looking at all mergers or even all hostile mergers, to focus on some of these aspects?

Mr. **Brady**. Well, when you talk about two-tier offers as opposed to just a flat offer, it is obviously a more simple proposition for shareholders in the world to evaluate if there is just one price for everybody. However, I think there are some takeovers, if not too much leverage is involved, where a two-tier thing is perfectly responsible.

Senator **Boren**. What about the greenmail payments?

Mr. **Brady**. Well, greenmail is a very controversial subject, and it is one that you can get quite exercised about on both sides of the argument.

I frankly am a member of a board of corporations that has just put in an anti-greenmail provision. I asked not to vote, on the theory that I don't need to be told when not to pay greenmail. I mean, I know it when I see it, as Senator Chafee just mentioned.

You know, greenmail has gotten to be a generic name for buying back your own stock. I mean, it happens to come in one lump. And more recently it comes with usually somebody that is threatening a takeover. But corporations with excess cash have been buying instocks for years, and it is very hard to come across a block—you have to buy it one share by one sometimes.

So again, it has gotten to a point where greenmail and poison pill and junk and all of those things remind me of playing monopoly as a kid. And I instinctively—I don't know why I don't like it, but I don't like it. But as for prohibiting it, I am not sure that that isn't too restrictive.

Senator **Boren**. Let me ask this. Of course in our bills we tax rapid escalation of the value of stock under certain circumstances—if the stock is held for a short period of time, if it is held by a person who institutes a hostile takeover, and if there is a rapid increase of the value of that stock due to the hostile tender and that group holds over a certain percentage, 4 percent I believe under our proposal. I am talking about making it less attractive financially but to make it more effective, the way the market is supposed to work.

In theory, the market is supposed to reorganize assets, either grouping them together or spinning them off in a way that will maximize the productivity, maximize the return, and make the most effective use of the assets.

But if you target in very short-term holdings for a short-term gain, by people who have made these offers, wouldn't that do a lot to—in other words, if you really wanted to get into this business it would be because you genuinely thought you could do either a better job of managing the company or reordering the assets of the company, and that you were going to stay there and be a player with it for a certain period of time, as opposed to just a "quick-hit artist" so to speak.

Mr. **Brady**. Yes. Well, I think it is a worthwhile path of inquiry. I think, Senator Boren, the problem is so many of these things are a sense of proportion and commonsense that I worry a little bit about a flat rule that stops any kind of repurchase.

Suppose you were going to buy in some stock that had been accumulated a couple of points under the market. I don't see too much trouble with that. And if that amount of stock wasn't going to inhibit the future operations of the corporation, fine. But, you know, I think it is the sense of how you look at it, proportion.

Senator **Boren**. But suppose there are some people who do just start these things because they don't intend to take over the company? And it's very hard. It is very hard in some circumstances to determine what the motivation is. But let's presume there are some people who want to just do that—they want to simply play short term to speculate, to make an immediate gain. They are not even willing to hold their stock any lengthy period of time, a couple of years. Shouldn't there be some way in which you try to close the door to that kind of operation?

Mr. **Brady**. I think it might be——

Senator **Boren**. I mean by taxing it. I am not talking about prohibiting it; I am talking about making it less financially attractive, unless you really want to hold your stock for a long enough period of time to be a productive, beneficial participant, you might say, either as an investor or a manager.

Mr. **Brady**. Well, it might be hard. Again, I apologize; I haven't studied the particulars of this thought as much as I should have, probably, before I came this morning. But I think it might be hard to judge the motives of one person who is offering stock to a corporation from another. That would be very hard to do, I would think, and that point of it would bother me somewhat.

Senator **Chafee**. Thank you, Senator Boren.

Well, thank you very much, Senator Brady. It is great to see you back again, and your advice as always has been very, very helpful to us. This committee will stay in touch with you as we go along, as we wrestle with this difficult problem.

Mr. **Brady**. Thank you, Mr. Chairman.

Senator **Chafee**. I am glad you came down.

All right. The next panel is Secretary Pearlman and Mr. Cox.

Mr. Pearlman, why don't you proceed? We have quite a list of witnesses here, and we are going to have to restrict the witnesses to 5 minutes.

Mr. Pearlman, you have a statement?

STATEMENT OF RONALD A. PEARLMAN, ASSISTANT SECRETARY FOR TAX POLICY, DEPARTMENT OF THE TREASURY, WASHINGTON, DC

Mr. **Pearlman**. I have a statement, and obviously I won't go through that. I will try to summarize very quickly, Mr. Chairman.

Let me first just indicate that the statement bears a legend at this point that it has not yet been reviewed by OMB. That is not totally accurate, but they have not formally indicated their concurrence, and we will transmit that to you this afternoon. We expect to have it then.

Senator CHAFEE. Well, you are not going to worry this committee if your statement hasn't been reviewed by OMB, so you proceed. [Laughter.]

Mr. PEARLMAN. And you are not going to get me to respond to that one, either. [Laughter.]

Unfortunately, Mr. Chairman, it is always not particularly pleasant to come up and oppose bills that are supported by the chairman and a number of the members, but we are constrained to do that.

I think I can convey the Treasury's view here in a couple of very general statements and then perhaps address the specific provisions more quickly that way.

I don't think we want to be in a position of making economic judgments about whether particular acquisitions, whether they be hostile or friendly, are good or bad for the economy, if for no other reason than that we probably don't know.

One thing we think we know, based on some history with the tax law, is that the more we get the tax law into making those decisions, the more we confuse the law, and perhaps the more we distort economic behavior.

So what we suggest here in opposition to these bills is that as a matter of tax policy we think it is undesirable to try to draw lines that say that in hostile acquisitions there should be one kind of tax treatment, and in friendly acquisitions another, that if there is going to be an interest deduction for debt, if there is going to be a section 338 election available for acquisitions, that the deduction and the availability of a 338 election should be equally available without regard to whether the acquisition is hostile or friendly.

Similarly, we do not think it is appropriate to deal with the problem of greenmail profits through an excise tax. The implication of imposing a tax, which essentially makes the greenmail profits subject to a confiscatory tax—that is, when added to the regular tax would mean the tax rate would be 100 percent—obviously has to have an effect on economic behavior, which, again, we believe is not appropriately or should not be appropriately governed by the tax laws.

I am going to avoid going into the details of these bills, Mr. Chairman, because of your time constraints. But let me indicate that I think there are serious problems in trying to define a hostile takeover. I think it easy to sit here and say we know what a hostile takeover is; but when it comes to drafting a tax statute and having to make tax consequences turn on the number of directors, whether they are independent or inside directors' vote, I suspect we are going to all find it is going to be a lot more difficult than simply putting words on a piece of paper.

I would like to make a comment about junk bonds. We have indicated, I think on a consistent basis, that we are concerned about the preference in the tax system toward debt finance. It is one of the things that has been a major issue to us in our exploration of options to fundamentally reform the tax system.

The issue here again is, do we do something either in an acquisition context in general that is different than what we might do in another context in which debt is issued by a corporation, or in specific kinds of acquisitions—that is, hostile versus friendly? And again, we would suggest to you that it is inappropriate to draw those kinds of distinctions in the tax law.

Certainly we do not want to prohibit corporations from issuing a variety of instruments. Venture capital companies, for example, won't be able to issue obligations of the same grade that more mature companies could issue. We don't want to interfere with that, presumably, in the tax system.

When we go down the road of saying, "What is a junk bond? And what is not? And who can issue it? And who cannot? And in what circumstance should it be able to be issued, and in what circumstance not?" Again, I would suggest that we are treading a dangerous path.

I want to make one final comment, if you will permit me, even though the bell has wrung. That is, with respect to the deductibility of greenmail payments by a payor corporation, the line of the discussion this morning has indicated—and I know it is not unique to the discussion this morning—has indicated a general assumption that those greenmail payments paid by a corporation are deductible. I want to go on record to indicate to you that we believe under current law they are not, that they are payments in redemption of stock, and that although there is some case law—one case to be specific—that suggests under a very limited set of circumstances redemption payments may be deductible, we believe and the Internal Revenue Service believes that greenmail payments are simply payments in redemption of stock and are nondeductible under current law.

I would urge you, if you choose to confirm that position by legislation, that you do not disturb what we believe is current law, and that you not draw lines that would suggest payments in redemption of stock which we believe are currently nondeductible might be viewed as deductible by reason of any dividing lines—percentage of ownership, for example, or percentage of profit—lines that might be drawn as a result of any legislation.

Mr. Chairman, I am going to stop at this point. I will be happy to try to answer your questions.

Senator **Chafee**. We will go ahead with Mr. Cox, but I want to ask you one quick question. What about when the targeted company pays not only greenmail for the purchase of the stock but also pays the raider's attorneys fees? Now, are those deductible? That has actually taken place. Is that deductible by the targeted corporation?

Mr. **Pearlman**. We would view any payments made by the issuing company that are incident to the reacquisition of stock as part of the cost of the reacquisition of stock. So how the consideration is split up, whether part of it is for attorneys fees or other costs of the selling shareholder, would not, as far as we are concerned, change its character.

Senator **Chafee**. So none of it is deductible?

Mr. **Pearlman**. As far as we are concerned, none of it is deductible. That's right.

Senator **Chafee**. All right. Mr. Cox?

[Mr. Pearlman's written testimony follows:]

Not Reviewed by the Office of Management and Budget
Due to Time Constraints

For Release Upon Delivery
Expected at 9:30 A.M., E.S.T.
April 22, 1985

STATEMENT OF
RONALD A. PEARLMAN
ASSISTANT SECRETARY (TAX POLICY)
DEPARTMENT OF THE TREASURY
BEFORE THE
SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE
SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I am pleased to appear before you today to present the views of the Treasury Department on three bills (S. 476, S. 420, and S. 632) relating to corporate acquisitions. These bills appear to be prompted by the recent surge in merger activity generally, but are particularly directed at hostile merger activity. The bills would substantially penalize, if not render economically impossible, mergers and acquisitions that are considered "hostile."

We do not believe that Congress should enact special tax provisions aimed only at hostile as opposed to friendly acquisitions. Indeed, we do not believe that Congress should amend the tax laws for the purpose of discouraging mergers and acquisition activity generally.

We do not know all of the economic and other reasons behind the recent flurry of activity. We doubt, however, that the tax laws are the driving force, but rather suspect that other market forces precipitate these transactions; forces that reallocate resources to higher valued uses, promote economies of scale, increase shareholders' return on investment, replace inefficient management, and free up capital for new investment opportunities. Only those persons responsible for the merger activity know for certain the forces that drive their decisions.

The bills that are the subject of today's hearing would discourage hostile takeovers by disallowing interest deductions with respect to certain indebtedness and mandating a section 338 election for certain stock purchases. In addition, the bills would discourage attempted takeovers by imposing an excise tax on certain profits realized by persons who take substantial investment positions in companies that are the subject of an attempted takeover. These profits have recently been referred to as greenmail profits. The bills also would clarify that under current law no deduction is available with respect to any greenmail payments.

The Treasury Department opposes these bills. As a matter of tax policy, we do not believe hostile acquisitions should be treated differently under the tax laws than friendly acquisitions, nor do we believe that a clear distinction can be drawn. Thus, we believe that interest deductions and section 338 elections should be equally available for hostile and friendly acquisitions. Further, we do not believe that certain gains from sales or exchanges of stock, labeled greenmail profits, should be subject to an excise tax. Finally, while greenmail payments are not deductible under current law, we would not be opposed to a statutory confirmation of this point.

Hostile Versus Friendly Acquisitions

All of the bills that are the subject of today's hearing would limit interest deductions, and both S. 632 and S. 420 would mandate section 338 elections, for all hostile acquisitions. Hostile acquisitions are defined in two different ways, however. S. 476 defines the term "hostile acquisition" generally as an acquisition of corporate property or stock by persons who have acquired a 20 percent or greater interest in the target corporation within the preceding year, if the transaction, before consummation, is not formally approved by a majority (consisting of at least two members) of the independent members of the board of directors of the target corporation. No member of the board would be treated as independent if such member is an officer or employee of the corporation or was nominated by the persons making the acquisition.

Both S. 632 and S. 420, framed more broadly than S. 476, apply to acquisitions by any persons, if the acquisition is pursuant to a "hostile offer." The term "hostile offer" turns on the same factor as S. 476 -- disapproval by a majority (consisting of at least two members) of the independent members of the board of directors of the target corporation. The definition of an independent director is more restrictive under S. 632 and S. 420 than S. 476, as it not only excludes from the definition a person that is an officer or employee of the target corporation, but also any person that has substantial financial or commercial ties to that corporation, except for ownership of stock.

We do not believe the tax consequences of corporate acquisitions should turn on whether a corporation's independent directors approve or disapprove of the acquisition. Moreover, the effect of these bills would be to bring new and extreme pressure to bear on the decision making processes of independent directors. Because of the harsh tax consequences resulting from characterization of an acquisition as hostile, independent directors would in effect have a veto over corporate acquisition decisions. On the other hand, there may be substantial enough pressures on the independent directors that would, under certain circumstances, tend to make them vote for, rather than against, a proposed acquisition. For only by their favorable votes could the sanctions imposed by these bills be avoided. Such pressures would seem to undermine the very rationale for independent directors.

Further, many closely held corporations do not have independent members on their boards of directors. In such cases, the tax penalties could not come into play no matter how vigorously a takeover is resisted. The bills do not suggest any rationale for this arbitrary distinction. If these tax penalty provisions were enacted, however, companies would have an incentive not to have independent directors. We doubt that the sponsors of the bills intend such a result.

We believe very strongly that the market place (i.e., shareholders rather than independent directors) should determine whether a proposed acquisition is economically beneficial. The tax laws should not bias this decision towards friendly or against hostile acquisitions, as a hostile acquisition may turn out to be an economically beneficiary acquisition. Only a free market can make the optimal economic decision.

Disallowance of Interest Deductions on Certain Hostile Acquisitions

All of the bills before the Subcommittee limit the deductibility of interest incurred in connection with "hostile" takeovers. The genesis of these bills apparently stems from the publicity received by a number of recent acquisitions financed by the use of so-called junk bonds (i.e., high risk, high yield subordinated debt) and a concern that the current tax treatment of interest may encourage mergers, especially hostile acquisitions. The basic structure of our current income tax system may encourage corporations to utilize debt rather than equity in financing operations or acquisitions because of the more favorable tax treatment of interest compared to dividends and the arbitrage potential from debt financing.

S. 476 would disallow a deduction for any interest paid or accrued during the taxable year with respect to "hostile acquisition indebtedness." Hostile acquisition indebtedness is defined as any "junior obligation" issued after February 18, 1985, in connection with a hostile acquisition. A "junior obligation" is any obligation evidenced by a bond, debenture, note or certificate, or other evidence of indebtedness issued by any person which, upon issuance, bears any one or more of the following characteristics: (1) the indebtedness is expressly subordinated to the payment of any substantial amount of unsecured indebtedness of the issuer or the corporation that is the target of the hostile acquisition, (2) the indebtedness is issued by a person whose assets are (or following the hostile acquisition would be) comprised predominantly of the stock of the target corporation, cash, and cash equivalents, or (3) the indebtedness bears a rating from any nationally recognized rating agency which is at least two ratings inferior to the rating from such agency in respect of any other substantial class of indebtedness of the issuer or the target corporation. S. 476 is effective with respect to interest paid or accrued with respect to obligations issued after February 18, 1985.

S. 632 differs slightly from S. 476 in that it disallows a deduction for any interest paid or accrued on indebtedness incurred or continued to acquire (or carry) stock or assets acquired pursuant to a "hostile offer." The definition of "hostile offer" differs only slightly from the definition of "hostile acquisition" in S. 476 as discussed above. S. 632 is effective with respect to indebtedness incurred or continued to acquire (or carry) stock acquired after March 6, 1985. For assets acquired pursuant to a "hostile offer," S. 632 fails to provide a specific effective date for its application to indebtedness incurred or continued to acquire (or carry) such assets.

S. 420 is identical to S. 632 with respect to the disallowance of interest deductions, except that it does not apply to indebtedness incurred or continued to acquire (or carry) assets; it is limited to acquisitions of stock. S. 420 is effective with respect to indebtedness incurred or continued to acquire (or carry) stock which is acquired after February 6, 1985.

Our current income tax system generally treats corporations as taxpaying entities separate from their shareholders. A corporation separately computes and reports its taxable income, and in making this calculation it is not entitled to a deduction for dividends paid to shareholders. Moreover, these dividends are taxed to individual shareholders as ordinary income (except for a $100 per year exclusion). Consequently, corporate taxable income paid as dividends to individual shareholders generally bears two taxes, the corporate income tax and the individual income tax.

The double taxation of corporate earnings that are distributed as dividends to shareholders affects dividend distribution policies in ways that may encourage merger activity. In particular, corporations, especially those with shareholders in relatively high income tax brackets, are encouraged to retain earnings in order to allow the shareholders to defer imposition of the second tax.*/ This pressure to accumulate corporate earnings not only interferes with ordinary market incentives to place funds in the hands of the most efficient users, but also stimulates corporate acquisitions in at least two ways.

First, corporations that accumulate cash funds in excess of their needs for working capital must reinvest those funds; acquiring the stock or assets of other corporations is an investment alternative that must be considered by any corporation with excess funds to invest. Second, a corporation with large amounts of funds invested in nonoperating assets may itself become an attractive target, because the market may not immediately reflect the value of those nonoperating assets (which may not generate financial reported earnings commensurate with their values). Because of this potential undervaluation of the target's nonoperating assets, a potential acquiring corporation may view the nonoperating asset as cheap funds available to finance the acquisition of the underlying business operations of the target. The mitigation or elimination of the double tax on corporate dividends, through any form of integration of the corporate and individual income taxes, would reduce or eliminate these effects.

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*/ Indeed, in some cases the shareholder-level tax can be permanently avoided if the retained earnings are distributed in liquidation following the death of the shareholder, which occasions a tax-free increase in the stock's basis to its fair market value. However, if the corporation is formed or availed of for the purpose of avoiding the second shareholder-level tax by permitting earnings and profits to accumulate instead of being distributed, there is imposed on the corporation a penalty accumulated earnings tax.

In contrast to the taxation of corporate earnings distributed as dividends, corporate income distributed to creditors as interest is deductible by the corporation and thus taxed only once, to the creditors. The disparate tax treatment of debt and equity in the corporate sector distorts decisions regarding a corporation's capitalization, making corporations more vulnerable to takeover during economic downturns, and also may encourage leveraged buyouts, because interest payments on the debt incurred in such a transaction offset income earned by the target corporation.

Since interest payments on debt financing are deductible and dividends paid on equity are not, corporations are encouraged by the tax law to utilize debt rather than equity to finance their ongoing operations. This may result in an increased debt-to-equity ratio that increases the risk of bankruptcy and vulnerability to downturns in the business cycle; and any corporation that is temporarily crippled by an economic downturn becomes a likely takeover candidate.

The deductibility of interest incurred in connection with debt-financed acquisitions also encourages acquisitions to the extent that our tax system does not take account of inflation properly. Nominal interest rates typically include an inflation component which compensates the lender for the anticipated future reduction in the real value of a fixed dollar amount debt obligation and acts as an offsetting charge to the borrower for the inflationary reduction in the value of the principal amount of the borrowing. Where borrowed funds are invested in assets that also increase in value by virtue of inflation, the tax law permits a current deduction for interest expense but no realization of the increase in value of the asset until its sale or disposition. In such cases, the interest deduction can be used to offset income that otherwise would be taxed currently.

The use of installment debt in acquisitions also leads to significant mismatching of the gain that is deferred by the seller and the allowance to the purchaser of depreciation, amortization, or depletion deductions determined by reference to asset values that have been stepped-up to fair market value as a result of the acquisition. This asymmetrical treatment of a sale, under which the buyer is treated as acquiring full ownership of the asset while the seller is treated as making only partial sales each year over the term of the contract may create a tax bias for installment debt-financed acquisitions. In a taxable corporate acquisition (an asset acquisition or a stock acquisition with a section 338 election), this mismatching is reduced to some extent if the target corporation's assets are subject to recapture tax since the recapture income is recognized immediately. The asymmetrical treatment arising from installment sales debt is a problem that should concern this Subcommittee, but the problem exists in every installment sale of a depreciable asset and is by no means unique to corporate acquisitions.

One of the bills, S. 476, would deny deductions for interest paid on high yield, subordinated bonds used to finance hostile acquisitions. The concern generating the bill may have been that a number of these bonds, referred to as "junk bonds," have been used in connection with recent highly leveraged acquisitions. There is a substantial argument that some of these bonds would be more appropriately classified as equity rather than debt. Although there are significant differences in the tax treatment of debt versus equity, it is extremely difficult to develop general rules to differentiate a debt interest from an equity interest. Section 385 lists certain factors that are to be taken into account in distinguishing debt from equity interests. Although section 385 was enacted in 1969, to date no satisfactory general rules have been developed. The Internal Revenue Service has administered this area, and will continue to differentiate instruments including junk bonds, on a case by case basis. S. 476 does not consider any facts and circumstances other than those enumerated in its definition of junior obligation and, therefore, may inappropriately characterize some junior obligations as equity.

Two of the bills before the Subcommittee, S. 632 and S. 420, address the disparate treatment of debt and equity and the potential arbitrage from debt financing by limiting interest deductions on all indebtedness incurred or continued in connection with hostile acquisitions. The tax arbitrage from debt financing generally is available, however, for all debt-financed corporate assets, not just those acquired in a corporate merger or acquisition. The only special limitation on the deductibility of interest on debt incurred in acquisitions is found in section 279 which applies only under very limited circumstances. Although it may be appropriate to give consideration to revising the general rules regarding the deductibility of interest, we see no justification for a further limitation on the deductibility of interest expense that is aimed specifically at debt incurred in connection with hostile acquisitions. Any tax advantage to utilizing debt in a corporate acquisition is available both to hostile as well as friendly acquisitions. We believe that any remedy to limit the advantage to utilizing debt rather than equity to finance corporate acquisitions should be done in a neutral manner.

Mandatory Section 338 Election in the Case of Hostile Stock Purchases

Two of the bills before the Subcommittee mandate that in a hostile stock acquisition, the acquiring company is deemed to have made a section 338 election for the target corporation, and that certain other provisions of the tax law that generally apply when a section 338 election is made, do not apply.

Generally, as described above, a corporation is subject to tax on the profits derived from its operations and its shareholders are subject to a second level of tax on the distributions of those profits as dividends. In a liquidating sale of assets or sale of stock subject to a a section 338 election, the acquiring company obtains the benefits of a step-up in basis of the acquired assets with only a partial corporate level tax; recapture and tax benefit items are taxed, but other potential gains are not. This result stems from the rule attributed to General Utilities & Operating Co. v. Helvering, 296 U.S. 200 (1935), that is now codified in sections 311(a), 336 and 337. Under those provisions, a corporation does not recognize gain (other than recapture and tax benefit items) on certain distributions, including liquidating distributions, made to its shareholders.

The General Utilities rule applies when a section 338 election is made. The election is available generally whenever one corporation purchases at least 80 percent of the stock of a target corporation over a 12-month period. If such election is made, the basis of the assets of the target corporation is adjusted in a manner similar to the adjustments that would occur if the target corporation had sold all of its assets to the acquiring corporation in connection with a plan for complete liquidation. The target corporation does not recognize gain (or loss) on such deemed sale (except for recapture and tax benefit items). The price at which the assets are deemed sold by the target corporation and purchased by the new corporation is generally the purchasing corporation's basis in the target's stock at the acquisition date.*/

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*/ Section 338(a)(1) provides that the target corporation is deemed to sell its assets at their fair market value on the acquisition date. Alternatively, in the case of a bargain stock purchase, an election may be made under section 338(h)(11) to determine the aggregate deemed sale price on the basis of a formula that takes into account the price paid for the target corporation's stock during the acquisition period (grossed-up to 100 percent) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items. Section 338(b) provides that the new corporation is deemed to purchase the target corporation's assets at an aggregate price equal to the grossed-up basis of recently purchased stock plus the basis of nonrecently purchased stock (subject to an election under section 338(b)(3) to step-up the basis of such nonrecently purchased stock) plus liabilities (including taxes on recapture and other tax benefit items generated in the deemed sale) and other relevant items.

There is generally no requirement that a purchasing corporation make a section 338 election for the target corporation. If no section 338 election is made for the target, no gain or loss is recognized with respect to target's assets and its corporate tax attributes are preserved, subject to certain limitations.

S. 632 provides that in the case of any hostile qualified stock purchase, the purchasing corporation will be treated as having made a section 338 election with respect to such purchase. In addition, all gain, not just recapture and tax benefit items, will be recognized on the deemed sale of assets. Moreover, the basis of the target's assets deemed purchased will be reduced by the amount of tax imposed on the target corporation as a result of the deemed sale. S. 632 is effective for hostile qualified stock purchases after March 6, 1985.

S. 420 is identical to S. 632, except that there is no requirement that the basis of target's assets deemed purchased be reduced by the amount of the tax imposed on the target corporation on the deemed sale. S. 420 is effective for hostile qualified stock purchases after February 6, 1985.

The availability of the section 338 election does not create any significant tax incentives for either hostile or friendly acquisitions. The provision was intended to facilitate mergers and acquisitions by permitting the acquiring corporation to replicate the tax consequences that would follow from an asset acquisition without requiring an actual sale and transfer of those assets. In many cases, however, the tax consequences of an actual asset acquisition or a deemed asset acquisition under section 338 will be adverse. Acquiring corporations have always been able to avoid such consequences by acquiring the stock of the target corporation and forgoing any adjustment in the basis of the assets of the target company. There are no tax policy considerations that suggest this latter alternative should be foreclosed to hostile takeovers. If a mandatory section 338 election were imposed, there would be a substantial bias in the tax law against hostile acquisitions of certain companies, especially those with large recapture and tax benefit items. We do not believe there is a sound tax policy reason for imposing that bias.

Similarly, we do not believe that there is any sound basis for imposing the additional tax penalties on hostile stock acquisitions that are proposed by S. 420 and S. 632. Whether all gains, not just recapture and tax benefit items, should be recognized on an actual liquidating sale of corporate assets or a deemed sale pursuant to a section 338 election, is not an issue that should turn on whether the acquisition is hostile or friendly. Finally, the reduction in basis for the tax liability generated on the deemed sale in a mandatory section 338 election prescribed by S. 632 is contrary to fundamental tax concepts, and amounts to an awkward and ill-conceived penalty on hostile acquisitions.

Excise Tax on Greenmail Profits and Deductibility of Greenmail Payments

Although the bills, as discussed above, generally attempt to distinguish between hostile and friendly acquisitions, they also deal with so-called "greenmail" paid and received in either hostile or friendly situations. As the term is commonly used, greenmail refers to a payment made by a corporation to a particular shareholder, often referred to as a "raider," who has purchased a substantial amount of the corporation's stock as part of a plan to acquire the corporation.*/ The offer to purchase the raider's stock is usually not made to all shareholders and is thus known as "greenmail." In exchange for the payment, the raider sells his stock to the target corporation and agrees to refrain from further attempts to acquire the corporation (a "standstill agreement"). Although the payment is made in exchange for the stock surrendered by the raider, it also may include reimbursement for expenses incurred by the raider in the takeover attempt.

In an attempt to eliminate greenmail payments, S. 476 and S. 420 impose a nondeductible 50 percent excise tax on any person who realizes "greenmail profits." Although greenmail, as described generally above, commonly refers to payments made by a corporation to an unwanted shareholder, both bills would sweep more broadly. In particular, greenmail profits are defined under

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*/ Because shares of a publicly traded target corporation are readily available for purchase on a stock exchange and the raider is generally not required to disclose his intentions until he has acquired five percent of the corporation's stock, the existence and identity of a potential raider may not be known by the target corporation until the raider has acquired the threshold five percent. Under the Williams Act, owners of five percent or more of a corporation's stock are required publicly to disclose the amount of their ownership and their plans with respect to the corporation. Accordingly, neither the target nor the market may be aware of a takeover attempt until the raider has acquired a substantial amount of stock.

S. 420 to include any gain realized by a "4-percent shareholder"*/ on the sale or exchange of any stock in the corporation if (1) the shareholder held such stock for a period of less than two years, and (2) there was a public tender offer for stock in the corporation at any time during the two-year period ending on the date of such sale or exchange. Under S. 476, greenmail profits also arise from a sale or exchange if, at any time during the two-year period, any 4-percent shareholder submitted a written proposal to such corporation which suggests or sets forth a plan involving a public tender offer, regardless of whether a public tender offer is actually made.**/

The tax would not apply, however, to a gain realized by any person on the sale or exchange of stock in any corporation if, throughout the 12-month period ending on the date of such sale or exchange, such person had been an officer, director, or employee of the corporation or a 4-percent shareholder. Under the bills, therefore, the 50 percent excise tax would generally apply to gains realized by relatively large, short-term shareholders. Both bills would be effective for sales and exchanges made after February 6, 1985, except for sales or exchanges made pursuant to a written agreement in existence on February 5, 1985.

The 50 percent excise tax proposed by both bills is deficient in several respects. First, the Treasury Department does not believe that any valid tax policy is served by subjecting greenmail profits to an additional tax. If greenmail payments are determined to be contrary to the public interest, they should be deterred directly, rather than through use of the tax laws. For example, state corporate laws could be amended to prohibit greenmail payments. Moreover, if such payments are judged by shareholders to be generally unacceptable, direct action may be taken. In particular, as many corporations have done, corporate charters may be amended to proscribe such payments.

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*/ Under both bills, a "4-percent shareholder" means any person who owns stock possessing four percent or more of the total combined voting power of all classes of stock entitled to vote. For purposes of determining whether a person is a 4-percent shareholder, stock owned both directly and indirectly (through the application of section 318) is considered.

**/ The term public tender offer is defined under both bills to mean any offer to purchase (or otherwise acquire) stock if the offer is required to be filed or registered with any Federal or state agency regulating securities.

In addition to the fact that the tax law is an inappropriate tool to deter greenmail payments, the technique adopted by the bills seems overly harsh and imprecise. Under current law, gains realized on a sale or exchange of stock are generally treated as capital gains. Assuming the shareholder had no capital losses, gains from the sale or exchange of stock held for six months or less are taxed as ordinary income at a maximum rate of 50 percent, while gains from stock held for more than six months receive preferential tax treatment. In particular, individuals and other noncorporate taxpayers may exclude 60 percent of the gain from income, and corporations are subject to a maximum rate of 28 percent on such gain. Under the bills, therefore, an individual shareholder who owned four percent of a corporation's stock for six months or less at the time of the sale could be subject to a 100 percent tax on any gain, a 50 percent ordinary income tax and the 50 percent excise tax.*/ The Treasury Department does not believe that such a confiscatory rate of tax is appropriate under any circumstances.

Moreover, we believe that a 4-percent shareholder, like any other investor, is subject to the vagaries of the market and should be taxed as any other investor. We perceive no tax policy rationale for taxing a larger shareholder at a higher rate than a smaller shareholder on an identical economic gain.

In addition, although the bills are styled as imposing an excise tax on "greenmail," their reach is much broader. In particular, the excise tax would apply to any investor who purchased more than four percent of a corporation's stock, regardless of whether the shareholder purchased the stock with an intent to acquire the entire corporation. Such large shareholders could include a variety of institutional investors, such as pension plans, college and museum endowment funds, and large private investors. While such investors normally hold stock for periods of longer than one year, and would thus be excluded from the excise tax under both bills, situations would arise in which such investors, who had recently purchased stock, would want to sell. These situations would include a variety of circumstances under which institutions may be forced to liquidate an investment for external reasons, as well as the simple desire to take advantage of appreciation caused by an actual or anticipated public tender offer. We do not believe that such investors should be subject to the punitive tax proposed by the bills.*/ While such large shareholders could avoid application of the excise tax by holding their stock for more than one year, such potentially noneconomic behavior should not be required by the tax laws.**/

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*/ Even if the shareholder had held the stock at the time of the sale for more than six months, but less than one year, the gain could be taxed at 70 percent. Corporate shareholders, depending on the length of their holding periods, would be subject to maximum effective rate of either 96 percent or 78 percent.

The final class of persons who might be subject to the greenmail excise tax are so-called "arbitrageurs." Such investors often take relatively large positions in a corporation's stock in anticipation of a tender offer at a price in excess of the prevailing market price. While such an investor may seek to benefit directly from a raider's attempt to acquire control of a corporation, we do not believe that any tax policy justifies taxing such person at exorbitant rates.

In summary, the Treasury Department believes that S. 420 and S. 476 represent an imprecise and overly harsh response to a perceived problem that may not be a problem at all. In any event, the solution does not reside in the tax laws. Consequently, we oppose the excise tax provisions in both bills.

Focusing narrowly on the tax treatment of "greenmail" by the corporation, S. 632 provides expressly for the disallowance of a deduction for any "greenmail payment." A greenmail payment is defined by S. 632 as any payment made by a corporation in redemption of its stock from a 4-percent shareholder if (1) such shareholder held such stock for a period of less than two years, and (2) there was a public tender offer for stock in the corporation at any time during the two-year period ending on the date of such sale or exchange. A greenmail payment also would include any payment to a 4-percent shareholder or other person for any expenses paid or incurred in connection with a redemption or public tender offer. Like S. 476 and S. 420, the term 4-percent shareholder does not include a person who holds at least four percent of the total voting power of the corporation's stock throughout the one-year period preceding the redemption or who was an officer, director, or employee of the corporation throughout that period. There is no specific effective date for these provisions in S. 632.

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*/ Even if institutions that are exempt from the income tax also were exempted from the excise tax, it would still fall inappropriately on some large taxable investors.

**/ The one year exception in the bill would permit a raider to avoid the excise tax simply by holding a four percent interest for one year. While business and other factors might preclude the use of such a tactic, the exception will diminish the effectiveness of the provision.

Under current law, the repurchase of stock by a corporation, regardless of the amount of stock owned by the shareholder from whom the stock is redeemed, is a capital transaction that can not give rise to a deductible loss and payments made by a corporation in such a transaction are not deductible.*/ Consequently, the Treasury Department believes that the provision of S. 632 denying a deduction for redemption payments made to a 4-percent shareholder under certain circumstances represents a limited restatement of current law principles.

S. 632, however, contains an exception for redemption payments made to a shareholder who, throughout the one-year period preceding the redemption, was an officer, director, or employee of the corporation or a 4-percent shareholder. Moreover, S. 632 does not apply to redemption payments made to a shareholder who owns stock possessing less than four percent of the voting power of all the corporation's stock. Because redemption payments are not generally deductible under existing law regardless of the size or identity of the redeemed shareholder, we believe that S. 632 is defective to the extent that it suggests that redemption payments made to such shareholders could be deducted by a corporation.

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*/ The courts have held repeatedly that an amount paid by a corporation to redeem its stock is a nondeductible capital transaction. See H. and G. Industries, Inc. v. Commissioner, 495 F.2d 653 (3d Cir. 1974); Jim Walter Corp. v. United States, 498 F.2d 638 (5th Cir. 1974); Richmond, Fredericksburg and Potomac Railroad Co. v. Commissioner, 528 F.2d 917 (4th Cir. 1975); Markham & Brown, Inc. v. United States, 648 F.2d 1043 (5th Cir. 1981); Harder Services, Inc. v. Commissioner, 67 T.C. 584 (1976); Proskauer v. Commissioner, 46 T.C.M. 679 (1983). In one isolated case, Five Star Manufacturing Co. v. Commissioner, 355 F.2d 724 (5th Cir. 1966), a court held that an amount paid by a corporation to repurchase its own stock was a deductible business expense in light of a showing that liquidation of the corporation was imminent in the absence of the redemption, no value would have been realized by the shareholders upon such a liquidation, and the redemption represented the only chance for the corporation's survival. Regardless of whether Five Star Manufacturing was correctly decided, it has since been strictly limited to its unusual facts, see, e.g., Jim Walter Corp, supra, and its continuing vitality, even on those unusual facts, is unclear, see Woodward v. Commissioner, 397 U.S. 572 (1970).

Despite the clarity of existing law and repeated losses in litigation, some corporations engaged in takeover fights have apparently taken the position that redemption payments may be deductible for Federal income tax purposes on the theory that they are made to "save" the corporation. We believe that treating redemption payments as deductible expenses under the circumstances contemplated by S. 632 is inconsistent with existing law. Nevertheless, we would not object to an express statutory confirmation that existing law bars the deductibility of redemption payments. If such an amendment were adopted, however, it should expressly deny deductibility for all redemption payments, regardless of the size or status of the shareholder, and the accompanying legislative history should state clearly that the amendment does not create any inference that the Congress believes such payments are deductible under existing law.

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This concludes my prepared remarks. I would be happy to respond to your questions.

STATEMENT OF CHARLES C. COX, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

Mr. Cox. Mr. Chairman, members of the committee, I appreciate this opportunity to testify about the tender offer process and the Securities and Exchange Commission's experiences and practices in administering the Williams Act.

The Commission has regulated tender offers in accordance with the Williams Act since 1968. In response to significant developments in takeovers during the years after the Williams Act was adopted, the Commission in 1983 established the Advisory Committee on Tender Offers. The committee's mandate was to review tender offer practices and to propose regulatory and legislative improvements for the benefit of shareholders.

The Commission has implemented some of the Advisory Committee's recommendations, continues to analyze others, and in 1984 submitted a legislative proposal in order to implement still other recommendations of the committee. The proposed legislation included provisions that would have shortened the 13(d) filing period and deterred greenmail.

On February 20, 1985, the Commission held an "Economic Forum on Tender Offers." The Forum provided valuable information from economists and members of the business community that will facilitate the Commission's continuing review of the tender offer area.

During the past year, regulatory concerns about tender offers have shifted from specific abusive practices to a more general debate about the social benefits of hostile tender offers. The Commission has taken the position that tender offers are not beneficial or harmful per se to the economy or securities markets generally, or to issuers or shareholders in particular. However, I have developed views based on my research as an economist and my experience as a member of the Securities and Exchange Commission. I propose to share my perspective with you today.

There are two competing theories about the benefits from hostile tender offers. The economists' view is that hostile tender offers generally benefit shareholders in both the target and bidding companies. Furthermore, they conclude that successful tender offers reallocate resources to higher valued uses and thereby benefit the economy.

An opposing hypothesis has been offered by corporate managers who are critical of hostile tender offers. They conclude that the threat of a hostile tender offer preoccupies corporate executives with propping up short-term earnings at the expense of investing in long-term projects such as research and development. Central to this short-term hyposthesis is the observation that institutional investors which are claimed to have a short-term horizon, have come to dominate the ownership of corporate equity.

What is the evidence?

Numerous studies by financial economists show the gains to shareholders. These can be summarized as follows: On average, shareholders in target corporations benefit by a 27 percent capital gain. Shareholders in bidding companies benefit by a 4 percent capital gain.

Another body of evidence shows that the stock market efficiently values corporate assets. Because of the efficiency of the market, economists conclude that the gains to shareholders from tender offers reflect reallocation of resources that benefit society.

So far, the critics of hostile tender offers have not presented any evidence to support their short-term hypothesis. In an effort to increase the Commission's knowledge about the tender offer process, the Office of the Chief Economist has been testing implications of the short-term hypothesis. Contrary to the critics' claims, the evidence shows the following:

First, the growth of institutional ownership of corporate stock has been accompanied by an increase in research and development expenditures. This fact contradicts the notion that the expansion of institutional ownership is forcing corporate managers to become more myopic.

Second, target firms exhibited lower, not higher, research and development to sales ratios than the industries in which they operate. This indicates that investment in long-term projects does not increase a firm's vulnerability to a takeover.

Third, institutional ownership in target firms was substantially lower than average institutional ownership in the firms' industries. Hence, the data contradict the assertion that high institutional ownership gives rise to hostile takeovers.

Fourth, reactions of stock prices show that the capital market positively values an announcement that a company is embarking on a research and development project. This evidence contradicts the argument that the market penalizes companies that invest in long-term projects and thereby makes them candidates for hostile takeovers.

To summarize, the available evidence consistently supports the theory that shareholders and the economy benefit from tender offers. At the same time, the available evidence contradicts the theory that the threat of a hostile takeover inflicts economic harm by leading corporate managers to concentrate on the short run at the expense of better corporate opportunities.

Thank you. I will answer any questions that you have.

[The prepared statement of Commissioner Charles E. Cox of the Securities and Exchange Commission follows:]

STATEMENT OF CHARLES C. COX, COMMISSIONER, SECURITIES AND EXCHANGE COMMISSION, BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE COMMITTEE ON FINANCE

APRIL 22, 1985

I appreciate this opportunity to testify about the tender offer process and the Commission's experience and practices in administering the Williams Act.

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The Commission has implemented some of the Advisory Committee's recommendations, continues to analyze others, and in 1984 submitted a legislative proposal in order to implement still other recommendations of the Committee. The proposed legislation included provisions that would have shortened the 13(d) filing period and deterred greenmail.

On February 20, 1985, the Commission held an "Economic Forum on Tender Offers." The Forum provided valuable information from economists and members of the business community that will facilitate the Commission's continuing review of the tender offer area.

During the past year, regulatory concerns about tender offers have shifted from specific abusive practices to a more general debate about the social benefits of hostile tender offers. The Commission has taken the position that tender offers are not beneficial or harmful *per se* to the economy or securities markets generally, or to issuers or shareholders in particular. However, I have developed my own view based on my research as a professional economist and my experience as a member of the Securities and

Exchange Commission. I propose to share my perspective with you today.

There are two competing theories about the benefits from hostile tender offers. The economists' view is that hostile tender offers generally benefit shareholders in both the target and bidding companies. Furthermore, they conclude that successful tender offers reallocate resources to higher valued uses and thereby benefit the economy. An opposing hypothesis has been offered by corporate managers who are critical of hostile tender offers. They conclude that the threat of a hostile tender offer preoccupies corporate executives with propping up short-term earnings at the expense of investing in long-term projects, such as research and development. Central to this short-term hypothesis is the observation that institutional investors, which are claimed to have short-time horizons, have come to dominate the ownership of corporate equity.

What is the evidence?

Numerous studies by financial economists show the gains to shareholders. These can be summarized as follows: On average, shareholders in target corporations benefit by a 27% capital gain. Shareholders in bidding companies benefit by a 4% capital gain.

Another body of evidence shows that the stock market efficiently values corporate assets. Because of the efficiency of the market, economists conclude that the gains to shareholders from tender offers reflect reallocation of resources that benefits society.

So far, the critics of hostile tender offers have not presented any evidence to support their short-term hypothesis. In an effort to increase the Commission's knowledge about the tender offer process, the Office of the Chief Economist has been testing implications of the short-term hypothesis. Contrary to the critics' claims, the evidence shows the following:

First, the growth of institutional ownership of corporate stock has been accompanied by an increase in research and development expenditures. This fact contradicts the notion that the expansion of institutional ownership is forcing corporate managers to become more myopic.

Second, target firms exhibited lower, not higher, R&D-to-sales ratios than the industries in which they operate. This indicates that investment in long-term projects does not increase a firm's vulnerability to a takeover.

Third, institutional ownership in target firms was substantially lower than average institutional ownership in the firms' industries. Hence, the data contradict the assertion that high institutional ownership gives rise to hostile takeovers.

Fourth, reactions of stock prices show that the capital market positively values an announcement that a company is embarking on an R&D project. This evidence contradicts the argument that the market penalizes companies that invest in long-term projects and thereby makes them candidates for hostile takeovers.

To summarize, the available evidence consistently supports the theory that shareholders and the economy benefit from tender offers. At the same time, the available evidence contradicts the theory that the threat of a hostile takeover inflicts economic harm by leading corporate managers to concentrate on the short run at the expense of better corporate opportunities.

Senator CHAFEE. I don't have a printed statement here. Do you have that information? Do you have your statement printed with references to that information?

Mr. COX. I have prepared these remarks to be spoken, but I can give you a copy of this, if you like.

Senator CHAFEE. I think that would be helpful to us, to all the members, yes.

Now, Mr. Pearlman, I gather from your statement that you don't think we ought to do anything. Is that about it?

Mr. PEARLMAN. I think there are two areas to which we all need to give some attention. I am not sure legislative attention is necessarily the answer. The one is the characterization of so-called junk bonds. I think there are debt-equity issues which need to be addressed in any issuance of corporate securities. It is a very difficult issue. We are all painfully aware of the problems that have arisen over the last 10 years or so as the Service has tried to put into force the mandate of the Congress in 1969 in connection with the debt-equity rules of section 385. But I think that is one area that needs some attention.

The other one, as I indicated before, is with respect to greenmail payments. If there is a perception on the part of the Congress or, in fact, if it were our view that there were some risk, some serious risk, that greenmail payments were deductible by corporations, we might seek to deal with that legislatively. I do not think we should try to deal with section 338 on a selective basis. I do not think we should try to deal with the disallowance of interest expense on a selective basis. Finally, I do not think an excise tax on greenmail profits is appropriate.

Senator CHAFEE. Well, that is the same testimony you gave or your predecessor gave when we were dealing with golden parachutes, if you recall, and we went ahead and did it, and it seems to have stopped the problem.

Without being harsh, it seems to me Treasury always takes the view that they don't like us to do things.

Mr. PEARLMAN. Mr. Chairman, I am very reluctant to comment on golden parachutes. I would just suggest this to you—and I don't want to prejudge the golden parachute legislation. But I would suggest this to you, that we are seeing some difficulties already in terms of the scope of the golden parachute legislation—that is, what kind of transactions which we do not believe the Congress intended to affect by the golden parachute legislation may be being affected. And I think that is a similar concern that we have here.

Senator CHAFEE. Mr. Cox, could you comment on Senator Brady's testimony? You were here and listened to it, and I think all of us put great credence in what Senator Brady says and are concerned. Yet, you don't seem to have the same concerns.

Mr. COX. As far as the problem of management's orientation being shifted toward the short run, I don't have those concerns until I see some concrete empirical evidence of that.

As far as the aspect of junk bonds—and I somewhat regret the pejorative term that is associated with those—I think, from the standpoint of the Securities and Exchange Commission which administers the disclosure rules, that to the extent that disclosure is full and accurate so that investors can make up their minds about the risks involved and the quality of those bonds, that disclosure is the proper way to regulate them.

It has been mentioned that the Federal Reserve and the Federal Home Loan Bank Board have made some statements with regard to banks or savings and loans investing in those bonds. And in that respect, I would leave that to the expertise of the banking regulators who are concerned with the safety and soundness of the banking system.

Senator CHAFEE. What do you think about the suggestion Senator Brady made of a moratorium on the so-called junk bonds for a while, while we consider this matter?

Mr. COX. I would not support the idea of a moratorium because I fear that perfectly legitimate uses could be precluded while there was such a moratorium. I think that full and accurate disclosure, as is required by the Securities and Exchange Commission, is a better route.

Senator CHAFEE. Senator Long.

Senator LONG. No questions, Mr. Chairman.

Senator CHAFEE. Senator Danforth.

Senator DANFORTH. Mr. Pearlman, Senator Brady testified that if we change the tax laws, people who are involved in these transactions would soon find ways to get around the new law. Do you agree with that?

Mr. PEARLMAN. I do agree with that, Senator. Before, just as I was preparing to testify, I went back and looked at the rarely looked at provision in the current Internal Revenue Code section 279 that was enacted some years ago to try to deal with the problem of issuing debt in acquisitions. I didn't go back to look and see how many times that provision has been applicable. I didn't seek to find that from the Internal Revenue Service, but my guess is that we could probably count that number on one hand. And the reason for that is obvious, because it sought to draw lines, and once those lines were drawn it was rather easy to go to the edqe of that line.

I think if one looks at the lines drawn in the bills before the subcommittee for consideration today, you will find the same thing, that whatever the lines are we can find that we are able to see people go right up to that line.

Senator DANFORTH. Treasury now is working on regulations relating to the distinction between debt and equity. Am I correct?

Mr. **Pearlman**. Treasury has been working on those regulations since 1969. I guess it would be accurate to say we are not actively doing anything with those regulations now, having been wounded on a number of occasions. But I think I guess I would have to say we are still working on them, just in spirit.

Senator **Danforth**. Do you think we shouldn't be holding our breath waiting for some decision as to whether or not junk bonds are debt or equity?

Mr. **Pearlman**. Well, I would—had your question been "hold your breath for the regulations," I would advise strongly against that.

I do think that it is appropriate for the Internal Revenue Service to examine debt-equity issues on a case-by-case basis.

Senator **Danforth**. How about on this basis: Is this worthwhile? Should we anticipate something happening in the near future? And if something does happen in the near future, will there be ways around this kind of definitional change?

Mr. **Pearlman**. Well, Senator, I think that the most one could reasonably expect from the Service or the Treasury in this area is some public views as to the proper tax characterization of obligations that have been issued in particular transactions. It is a factual question; it is a case-by-case kind of analysis. I think that is as much as we can reasonably do. Congress then can react to that as it wishes.

Senator **Danforth**. Back in 1982—I think it was 1982—we were considering whether to change the code with respect to corporate acquisitions. The feeling that some people had at that time was that the Internal Revenue Code wasn't neutral, that, in fact, it encouraged acquisitions.

At that time there was some sort of study underway with respect to subchapter C. I don't know what the status of that is. But, in any event, the thought at the time was that we were not working with a neutral tax code but one which was biased toward acquisitions.

Obviously, the legislation that has been proposed and is under consideration today is not neutral either; it is strongly biased against acquisitions of this type.

Do you think that the code is neutral today?

Mr. **Pearlman**. No; I do not think the code is neutral today, Senator Danforth; I think there are biases in favor of corporations going through acquisition transactions. But those biases are very general biases. I mentioned the preference of debt financing.

The principal bias in the Tax Code that might encourage a corporation to either look for a suitor or be interested in being acquired, in my judgment, is the double taxation of corporate earnings. If we properly dealt with that issue in our tax system, then in my judgment much of the bias—the bias, for example, of debt over equity—would be removed and we would have a much more neutral system. With that bias, I think there will be a preference, in certain circumstances, toward the acquisitive route.

Senator **Chafee**. Senator Pryor.

Senator **Pryor**. No questions, Mr. Chairman.

Senator **Chafee**. Senator Bentsen.

Senator **Bentsen**. Thank you very much, Mr. Chairman.

Mr. Pearlman, what you are really saying is there is not much change in section 338, other than perhaps the clarification of redemption through the greenmail route, of saying that that certainly is not an expense, that that is a repurchase of your own stock. Would you say that, or not?

Mr. PEARLMAN. That is correct, Senator.

Senator BENTSEN. Well, I am sympathetic to that point of view. I can't imagine anyone having brass enough to try to call that an expense, redeeming your own stock. But I guess some of them try it.

Now, when we get to section 385, we tried to draw the line between debt and equity when? In 1969?

Mr. PEARLMAN. That is correct.

Senator BENTSEN. I don't know where you draw the line between junk, junkier, or junkiest bonds. I don't know how you decide one is equity and therefore you will not allow expensing of the interest.

Have you tried something on that in addition to what you had done previously? You said you get turned back.

Mr. PEARLMAN. As part of the section 385 regulations project, which has surfaced several versions of section 385 regulations, one of the things that the Treasury Department did seek to do was to look at some of the more esoteric kinds of securities that were being used in acquisition transactions or that might be anticipated to be used in acquisition transactions. And what we found was that it was (a) very difficult to articulate what was debt and what was equity under particular circumstances, and (b) once a determination was made, then it became a highly controversial item as to putting those rules into particular play. They produced what people viewed as inappropriate results depending on the circumstances.

My own judgment is, although I think it is important to seek to try to articulate general debt-equity rules that are available for people to be guided by, that it is essentially a case-by-case process, it always has been in this country. I think Congress, with good intent, tried to articulate some general rules in 1969, but we found that they were very difficult to generalize.

Senator BENTSEN. All right. You made a comment about the Federal tax on corporations. That has been a longstanding concern. And in the initial phase of the trial balloon on the tax bill from the administration—I am sorry, from the "word processor"—on the initial phase of that you gave, as I recall, a 50-percent credit on dividends?

Mr. PEARLMAN. Deduction.

Senator BENTSEN. Deduction.

You haven't met with much enthusiasm on that, have you, from the business community? Aren't there those that feel that is going to mean they are going to be under more pressure to pay dividends, and therefore not a great deal of support? Are you going to actually have that in your proposal, or not?

Mr. PEARLMAN. Well, I am going to dodge your second question until the President makes that decision.

Senator BENTSEN. All right, then give me your feelings about the first part of it.

Mr. PEARLMAN. Let me say this: Over the years the design of a corporate integration scheme—dividend relief of some kind—has received criticism by some members of the corporate community on the basis that it would improperly encourage dividends when funds could otherwise be better used within the corporation.

In designing the proposal that was in the Treasury report we used a vehicle—that is, the deduction at the corporate level—in part for the purpose of trying to send a message to corporations that there was a way to integrate the corporate and individual income tax systems in a way that would directly benefit the corporations, so that it would give tax reduction at the corporate level as well as having a benefit at the shareholder level.

Candidly, Senator, we have not heard strong opposition to our dividend relief provision on conceptual grounds. The opposition we have heard is that it costs some money, and could that money not be better used to do something else.

Senator **Bentsen**. Thank you.

Mr. Cox, I have no questions of you, I guess because I found myself pretty much in agreement with your statement.

Mr. Cox. Thank you.

Senator **Chafee**. Mr. Pearlman, do you think that the current tax provisions which allow property and casualty insurance companies to file consolidated returns with other types of companies contributes to the takeover, hostile or otherwise, of property and casualty companies?

Mr. **Pearlman**. Mr. Chairman, I think, in fairness, it would not be appropriate for me to answer that question, because I have not examined the extent to which property and casualty companies have been part of takeover transactions.

Let me say this: One of the things we have given a great deal of time to in our fundamental reform review is the proper taxation of property and casualty companies. It was part—we did have a recommendation in our report to the President. It was part of that process, and I would anticipate it will continue to be part of that process. Perhaps, I can amplify my response in a subsequent statement to you on that.

Senator **Chafee**. All right, that would be fine.

[Information not available at presstime.]

Senator **Chafee**. Also, Mr. Pearlman, if you are providing the Ways and Means Committee with an analysis of major hostile takeover transactions, we would like a copy of that information.

Mr. **Pearlman**. Certainly. We would provide that.

Senator **Chafee**. All right, fine.

[Information not available at presstime.]

Senator **Chafee**. Are there any other questions?

Senator **Long**. Yes, I would like to ask a question.

Senator **Chafee**. Senator Long.

Senator **Long**. There seems to be some doubt about the duty of a trustee under an employee stock-ownership plan with respect to a takeover proposal. Employees usually are concerned about the security of their jobs, and might feel that a takeover would jeopardize their employment.

It has been suggested that the trustee must accept the highest offer for the stock, even though the employees might be very much opposed to it because they feel that it would jeopardize their jobs.

Apparently, it is not clear just what the duty of the trustee is in that situation.

It would seem to me that if both the employees and the management feel that that stock should be voted against the takeover, that that is how it ought to be voted.

However, there is a third corner to that triangle, and that corner is the lender. A lender making a loan certainly has a right to require that stock be pledged as collateral and that the lender be privileged to vote that stock while the lender holds it.

If that were the case, I assume that the lender would have the right to insist that the stock be voted the way the lender thinks it ought to be voted.

In any event, I do not feel that the trustee should be required to vote the stock in favor of a takeover bid, particularly if such a vote were contrary to the wishes of the employer, the employees, and the lender.

Can you give me any suggestions you might have along those lines?

Mr. PEARLMAN. Senator, this is a subject I think that raises a much broader question. I will give you my personal view, and it is only that, and that is that I strongly believe that employees who are beneficiaries of employee stock-ownership plans should have the right to vote the stock for whatever the issue before the shareholders is. I think one of the defects in current law, in the current employee stock-ownership rules, is that trusts have the ability in certain circumstances to not give the right to vote to the employees. I think that if the employees did have the right to vote, then they would be able to react as they wished, for whatever reasons—whether it was job security or some other reason. As you suggest, I think that would be an improvement in the current employee stock-ownership rules. But I think that voting right should be much broader than just on this issue; I think it should extend to every issue.

Senator LONG. Generally, I have not favored a requirement that the right to vote the stock be passed through to the employees, mainly because such a requirement might make employers reluctant to set up ESOP plans.

In fact, I am familiar with cases where people have set plans and my impression is that the longer they have the plan, the more they are inclined to feel it is perfectly all right for the employees to vote the stock. But there is a great fear on behalf of many people that if they establish an ESOP the employees might vote the management out.

I think there is also a fear that as employees hold increasing amounts of stock, they might vote to pay all the income out in wages or dividends rather than put more away in terms of research and development and things of that sort.

For the reasons I just described, you might not require that employees be able to vote the stock; rather you might leave it discretionary with the management.

However, if you are talking about the situation where the management and the employees agree, that stock ought to be voted against that hostile takeover. I take it that you would agree that in that limited situation the stock should definitely be voted against the takeover?

Mr. **Pearlman**. Well, I think that if the stock that is in that trust is in that trust for the benefit of the employees, then I would say, if you could limit it to that situation, it is the employees that should make that decision; I don't think management should be making that decision. I mean, the avowed purpose for giving the powerful tax incentives we do in employee stock-ownership plans is to give employees ownership. And I would think on this issue if one were to conclude that you want to vary from current law and extend a voting right where it is not presently available, that it should be a voting right available to the employee beneficiaries of the trust.

Senator **Long**. Where the stock is not yet vested in the employee——

Mr. **Pearlman**. Yes?

Senator **Long** [continuing]. You have a more nebulous situation. In a case like that, I think management does have a right to assert itself more.

What is your thought, Mr. Cox?

Mr. **Cox**. I don't think that the Commission has taken a position on the issue. You have certainly raised an interesting question about this.

Let me ask Joe Connolly from the Division of Corporation Finance. Have we investigated that?

Mr. **Connolly**. No; the Commission has not. The people that we always turn to on questions on takeovers when ESOP's or employee benefit plans are involved, are the people in the Labor Department who administer the ERISA statute. We ask them to take a look at the transaction and to advise us whether there are any concerns under the Federal law.

We have noticed, though, Senator, that in recent transactions involving employee plans, there have been recent amendments to those plans to allow a passthrough for the tender decision to those employees for their vested portion of the plan.

Senator **Long**. I am aware of one situation in which the trustee, speaking I believe for the lender, advised the management that they would feel compelled to accept a high offer for the stock, even though the employees might be opposed to it. I think in that case the management moved to vest those voting rights in employees so the employees could vote the stock.

I read an article which caused me concern, where the view was expressed by a trustee that he thought it was his duty to accept the higher offer, even though the employees were opposed to it. I found it difficult to see how a trustee could feel that he was voting in the best interest of those employees when their view he was jeopardizing their jobs.

What is your thought about that?

Mr. **Cox**. Well, as I stated before, it does seem peculiar that, if this is a plan set up for the benefit of the employees, that it shouldn't be used to benefit them as they see fit. Although you did mention some circumstances where there are perhaps some questions as to the extent that the employees should be able to determine how those shares are used, not related to the tender offer.

So I guess my view on thinking about this for the few minutes since you asked the question is that my concern for other aspects of operating the employee stock ownership plan prevents me from simply making a general statement that I think it is a good idea.

With respect to tender offers, as Mr. Connolly just indicated, there are some plans that take account of employee preferences. That might be a good way to move, so that it could be limited and not get into the other areas of concern.

Senator **Long**. Thank you very much.

Senator **Chafee**. All right, fine. Thank you, gentlemen, very much. We appreciate your coming.

The next two witnesses are Mr. Pickens and Mr. Jacobs.

On behalf of Senator Durenberger, he apologizes that he couldn't be here this morning. He and some colleagues are at the White House discussing another kind of takeover, namely the one in Nicaragua. So he sends his thanks to you, Mr. Jacobs, and this goes to Mr. Norris as well.

Well, gentlemen, we are glad you are here. Mr. Pickens, you are the high priest of this movement, and you and I have seen eye to eye on many things. You were good enough to come and testify last year when I had my legislation up requiring every director to own 1,000 shares of a corporation. You feel, as I do, that directors have some responsibilities and that they all too often are supine and don't act on behalf of the stockholders.

So why don't you proceed, Mr. Pickens. You have a statement; you can do as you wish.

STATEMENT OF T. BOONE PICKENS, JR., PRESIDENT AND CHAIRMAN OF THE BOARD, MESA PETROLEUM CO., AMARILLO, TX

Mr. **Pickens**. Mr. Chairman, I will file that statement for the record.

Senator **Chafee**. Your statement will be in the record.

Mr. **Pickens**. And I will make some rather brief remarks here to restate my position, which is always easy for me to make. I come from the stockholders' viewpoint. I believe that people make their money and make the investment in a company, and they should have the right to decide whether they want to take a premium to market offer. They don't need a management with conflicts of interest for their own entrenchment to decide whether the offer is good or bad.

I don't think you need a management to tell the stockholders that have made their money to decide whether they should or shouldn't take an offer. It is that clear cut with me.

I think that to do anything further to entrench the entrenched management is wrong, and I have seen the Congress of this country criticize big business in America, and I think sometimes they criticize them with good reason. I am in agreement.

Then why do we fortify, or even think about fortifying these managements who we believe have not done a good job at times? Why do we want to lock them into their positions even further? These people in these jobs, management positions, serve at the pleasure of the stockholders, or they should, just as you serve at the pleasure of the voters, and the shareholders should have the same opportunity to get rid of these people if they want to.

Now, there are 42 million stockholders in America today, 42 million people that own stock in public-owned companies, and that's 100,000 stockholders per congressional district. There are a lot of people out there, and they are probably put together by about the best glue you could put anything together with—their own money. And they should not have any of their rights taken away from them. I believe that is going on all the time in corporate America—bylaw changes, poison pills. There is no reason to let these kinds of things continue to take place.

But don't change the tax laws or declare a moratorium or take any other action which would add greater risk to these stockholders' investments, or deny them a chance to make a decent profit.

Thank you.

Senator CHAFEE. Mr. Jacobs.

[Mr. Pickens' written testimony follows:]

Statement of T. Boone Pickens, Jr.
President and Chairman of the Board
Mesa Petroleum Co.
United States Senate
Subcommittee on Taxation and Debt Management
Senate Committee on Finance
Hearing on the Tax Treatment of Hostile Takeovers
April 22, 1985

Mr. Chairman, it is a pleasure for me to appear before you and to address the important issues relating to the tax treatment of hostile takeovers described in the April 1, 1985, press release of the Senate Finance Committee announcing today's hearing. I appreciate the opportunity to share my views on the economic and practical implications of proposed tax legislation designed largely for the purpose of discouraging corporate mergers and acquisitions.

While I am not a tax expert, I do understand the energy industry, in which a portion of recent takeover activity has taken place. Accordingly, I know what has, and what has not, been the primary motivation behind the recent merger activity in that industry.

For the reasons detailed below, I would urge the Subcommittee to move cautiously in considering the pending legislative proposals. It should reject misguided proposals that, in my view, reflect a basic misunderstanding of the realities of the marketplace, in general, and what is now occurring in the energy industry, in particular.

These bills implicitly assume, against the great weight of evidence, that mergers are somehow bad per se, and that it is appropriate to add provisions to the tax code specifically to discourage hostile takeovers. They overlook the overwhelming benefits of mergers that accrue to the economy and to its key participant, the American shareholder. These bills serve only to protect incumbent management, often to the detriment of shareholders. They are simplistically drawn and do not recognize the true cause of corporate mergers. The primary reason that the merger and acquisition trend is beneficial is that the merger process provides shareholders with a means for making corporate management accountable to the owners of the company.

Mr. Chairman, there is more involved here than simple tax considerations -- the public interest, shareholder interests, market interests, and energy policy interests are also involved, to name a few. Before I begin my discussion on those points, I would like to outline Mesa's accomplishments.

Mesa is a prime example of a small company that has grown through successful exploration and acquisition. Five years after incorporation in 1969 (with total assets of less than $2 million), Mesa tendered for and acquired another public corporation engaged in the production of hydrocarbons. This company was 20 times the size of Mesa. It was quickly assimilated into Mesa and the combined financial and human resources fueled the company's rapid growth.

Several years later in 1973, Mesa acquired another company as a white knight, and the procedure was repeated. In each instance, efficiencies of operation were greatly improved and return on shareholders' investments was enhanced.

We proved that through acquisitions, a larger and more profitable company could emerge. The expanded exploration budgets made possible by the business combinations resulted in a stronger company with greater long-term viability. These acquisitions provided both short- and long-term value to our shareholders.

Each year since its inception, Mesa has replaced and enhanced its reserve base. Replacement has been achieved primarily through intensive exploration and development. We have invested over $1.8 billion in offshore exploration and development in the Outer Continental Shelf and have an average interest of 30 percent in 50 offshore platforms. During the last five years, total additions to Mesa's liquid reserves before acquisitions represented 139 percent of production, and additions to natural gas reserves represented 187 percent of production. Our total assets today are approximately $4 billion and our net income last year was $254 million on revenues of $413 million.

In 1981, our capital budget was $420 million; this sum was twice our cash flow. In 1982, the budget was $320 million -- still in excess of cash flow; in 1983 it was $223 million; and the 1984 budget was $110 million, excluding the $500 million purchase of proved reserves (Mesa Royalty Trust). The 1985 budget is $90 million. This current budget represents about 40% of our cash flow--a percentage which is consistent with the practice in the industry. Our decision to bring capital expenditures in line with cash flows was a calculated decision based upon our concern over the near-term future of the oil and gas business. It had no relation to our having created royalty trusts or our having invested in other energy companies.

The most recent data covering the Fortune 500 companies shows that Mesa would be included in the top five energy companies in assets and net income per employee, and in net income as a percent of stockholders' equity. An investor who purchased 1,000 shares of Mesa for $10,000 when the company was founded in 1964 would now have, as a result of the stock splits and the creation of two royalty trusts, an investment with a market value of approximately $312,000.

In addition, Mesa ranks as the second largest independent oil and gas company in the U.S. on an equivalent BTU basis. The company reached its all-time production high in January of this year and topped it in February, producing 365 MMCFPD of gas per day and 11,967 of oil and liquids per day. Mesa has the capacity to produce 500 MMCFPD of gas per day.

Mesa's management understands that shareholders are the cornerstone of corporate America and the owners because they are the people who risk their money to invest in business. Mesa stock is valued by John S. Herold at $19 per share, and on April 19, 1985, its closing price was 17 3/4, over 93 percent of its appraised value. Our market price as compared to appraised value is strong because of our entrepreneurial management.

Now let's turn to the specific points I want to make about the restructuring of the energy industry and the effect legislative changes might have on that process.

First, mergers among energy companies are motivated by the market realities of an industry in transition. Recent acquisitions are driven primarily by the need of companies to replace diminishing reserves in the most economic fashion. The industry today is in the midst of an internal restructuring, which represents a response to existing market forces. Recent cutbacks in drilling simply reflect the realities of exploration economics: a scarcity of good drilling prospects, high finding costs, and stable energy prices. There is a serious question whether or not current energy prices afford sufficient economic incentive to explore in frontier areas.

Second, mergers are recognized by authorities in government and industry not to be primarily tax-motivated. In testimony before the Senate Finance Subcommittee on Energy and Agricultural Taxation last year on oil company mergers, and again on April 1, 1985, before the House Ways and Means Committee, Ronald Pearlman, Assistant Secretary of the Treasury for Tax Policy, stated that the current tax rules are not propelling the recent flurry of oil company acquisitions. Mr. Pearlman urged Congress not to amend the tax laws for the purpose of discouraging merger and acquisition transactions in general, or hostile takeovers in particular. George Keller, Chairman and Chief Executive Officer of Standard Oil Co. of California (SoCal), also stated emphatically before the Senate Finance Committee last year that the SoCal-Gulf merger was not made for tax purposes and that the idea of gaining tax benefits from the merger played absolutely no part in SoCal's thinking. Finally, I stated in questions posed by the Senate Judiciary Committee last year that tax considerations were not major factors in Mesa's bid for Gulf.

I might add that despite certain changes in the tax laws in 1982 and 1984, bids for oil and gas companies still occur. It will continue so long as investors recognize assets to be undervalued, providing the management the opportunity to enhance values for their own stockholders.

Third, a basic underlying cause of corporate mergers today is management inefficiency. As this year's Economic Report of the President correctly asserted, the American economy's success depends on competition. Competition should also play a significant role in what is a healthy market for corporate control. An active merger market is a healthy threat to incompetent management. It is good for the economy because it shifts corporate assets from poor managers to more efficient ones, as stated by many experts in the antitrust field, such as former Assistant Attorney General for Antitrust, J. Paul McGrath.

Further support for this view has come from the respected economist Michael Jensen, as quoted in USA Today, March 20, 1984:

> "The merger market is really part of the labor market for top corporate managers. There's no unemployment bureau for CEO's of billion dollar firms. . .[managers and directors] are appealing for help outside the market--legislative help to protect them from the market."

Mr. Jensen is saying simply that these managements are asking for "executive protection." The shareholder/management relationship is the ultimate form of the supervisor/employee relationship. As an employee, one is never "safe." If an employee doesn't do a good job, he runs the risk of having the supervisor ask for improved performance or even being fired. Managements are employed by shareholders and should be subject to the same unwritten rules. But most managements do not consider themselves to be employees and do not feel shareholders have the right to judge their performance.

Allow me to quote from Malachi Martin's The Individual and the Future of Organizations (1982):

> "Ownership has become progressively separated from management. In our America of the eighties, the owners of corporate shares are not the managers. The managers are not the owners. The non-managing shareholders have been reduced to a functionless state. They are bondholders -- in the hands of the non-owning managers. These managers, not the shareholders, control company property, determine the use of its means of production, decide how much, if anything, will be paid out annually to the 'owners,' the shareholders."

What we have here, Mr. Chairman, is a burgeoning system of power by managers, but without property ownership. Not only power over property, but power without property.

I think these views lend support to the widely held view that corporate mergers are not primarily motivated or driven by the tax laws. Other, and in many ways, more substantial forces are at work.

Fourth, proposed tax legislation will adversely affect shareholders. The key point to bear in mind in this debate is that companies involved in mergers are not owned by managements, but by shareholders. It is their interest which should be paramount. There are 42 million shareholders who own stock in publicly traded companies. This represents one out of six Americans, or 100,000 in each congressional district in the

United States. Stockholders place their investments in the hands of management and expect management will do its best to keep the market value of their investments as close as possible to its true value.

If investors are dissatisfied with management performance, they will serve notice on management to improve the return on assets left under its control. Too often, unresponsive managements give the small investor little choice but to sell. Restrictions on legitimate tender offers would deprive these investors of that basic property right, the right to sell.

Mesa would not invest if we did not believe that management would respond in a positive way to our ownership. Regrettably, the small investor can have a tough time getting management's attention.

Both the Getty family, large owners of Getty Oil, and the Keck family, large owners of Superior, had the financial clout, as we do, to confront managements and make them respond. In each case both large and small shareholders benefitted.

The great weight of evidence expressed in Congressional testimony last year on anti-merger legislation in the House and Senate, as well as again this year before three House Energy Committees, is that mergers have been beneficial to shareholders and the economy.

A number of studies have pointed out that target company shareholders who tender their shares benefit from a premium over the market price which averages in a range of 30-35 percent. For the bidder, the average gain is 3-4 percent. Legislative restrictions on mergers would deny to shareholders this premium and thus in effect would impose a new restraint on shareholder value.

Fifth, proposed tax legislation will adversely affect capital markets and the economy. The effect of tax legislation which impedes corporate acquisitions could be severe. Corporate acquisitions are an important goal of entrepreneurial activity in our economy. Private entrepreneurs, financed by venture capitalists, are the primary creators of new jobs and new businesses.

This issue is addressed in a recent article in the March 1985 edition of Financier Magazine. It notes that since 1965, 35 million new jobs have been created in the U.S. In that same period, the largest companies among the Fortune 500 lost three million jobs. A minimum of 85 percent of all corporations have subordinated debt which would be rated less than investment grade. Yet, a minimum of 80 percent of all jobs created since 1965 were created by corporations with debt rated less than "investment grade."

Mergers create wealth. They are a natural product of the economy's need to allocate capital efficiently. They operate to free investment capital from inefficient usage and permit it to flow to the innovative and efficient, thereby enhancing the creation of wealth. To establish prohibitive tax barriers to this type of activity would be to harden the arteries that carry the life blood of our economic system -- investment capital.

Arbitrary tax rules could also weaken our securities markets. They could adversely affect the willingness of investors to put their savings into corporate equities and thus impair the ability of corporations to raise capital. If the shareholder's right to sell is restricted, equity securities would no longer be as attractive for investment purposes. This would aggravate the existing bias in the tax law in favor of debt as compared to equity financing--ironically, the very condition that some proponents advance in support of anti-merger tax legislation. Once investor confidence is weakened, equity markets will deteriorate to the detriment of capital formation.

If legislation restricting mergers and tender offers is ever enacted into law, the Securities and Exchange Commission should, in the interest of fairness and full disclosure, require that all stock certificates contain an appropriate boldface legend: WARNING: IT'S THE LAW -- YOUR ABILITY TO REALIZE THE HIGHEST PRICE FOR THESE SHARES IS SEVERELY RESTRICTED.

Sixth, proposed tax legislation designed to thwart mergers in the petroleum industry might adversely affect energy exploration and drilling by inhibiting the most efficient combination resources and expertise. As stated in The New York Times on March 21, 1984:

> "The multibillion-dollar mergers reshaping the American oil industry may also offer new economies of scale that make exploration efforts more fruitful. . . . Thus, when these separate resources are thrown together in a merger, the reasoning goes, the company that emerges can select its drilling projects from a richer list using the combined and presumably enhanced expertise that also results."

Congress should not approve anti-merger tax legislation on the misbegotten notion that it would cause the energy industry management to drill more domestic wells. There is plenty of money in the industry today to drill all the economically feasible prospects that are available. Rigs are stacked because the economics of drilling are poor. The number of rigs working in the U.S. today is less than half the number that were working in December 1981. The high-water mark at that time was 4,531 operating rigs; today we have only 1,860 rigs running. Tampering with the tax laws would only reduce further the rig count.

Seventh, proposed tax legislation would adversely affect U.S. Treasury revenues. The Subcommittee should note that mergers increase federal revenues substantially, and that adoption of anti-merger tax proposals could result in the loss of these revenues. For example, premiums paid in merger transactions have been a major generator of capital gains tax revenues, and any specific tax restraint on mergers would result in a decline in portfolio values for shareholders, resulting in smaller gains or perhaps capital losses. Testimony in the Senate last year on the tax aspects of oil company mergers suggested that tax revenues from the SoCal-Gulf merger alone were estimated to be $2 billion. In the five takeover attempts in which Mesa Petroleum Co. has been involved, 750,000 shareholders have made a pre-tax profit of roughly $15 billion, and federal coffers have been enriched by over $3 billion in taxes.

Let me offer another example that illustrates my point. If one takes the underlying appraised values of the ten largest oil companies, and if management were to raise the stock price only to 75 percent of the companies' appraised values, it would enhance four million stockholders' values by some $75 billion. The tax revenues resulting from normal profit-taking, and the positive effect on the deficit, would be some $20 billion once the stock is sold.

Eighth, pending tax bills aimed to deter mergers are inherently flawed. The most simplistic proposal would deny the deductibility of interest on debt incurred to acquire another company, on the premise that current law represents a "tax subsidy" in favor of mergers. This is simply an incorrect characterization of the facts.

Our tax laws have always permitted corporations to deduct interest for funds borrowed, whether to purchase stock or real assets, to build a plant or equipment, to develop new products or for general operating purposes. There is no reason to view the acquisition of a company through a merger as any different than we would view the acquisition of these other properties. I see little basis to discriminate against mergers or hostile takeovers.

The Subcommittee should note also that the borrowing of funds does not create interest deductions for the borrower without creating corresponding interest income for the lenders, which is subject to tax.

Denying the interest deduction would also prevent the most efficient allocation of capital in our economy. This requires mechanisms to match willing buyers and sellers and the freedom of sellers to sell to the highest bidder. Income tax rules should not attempt to dictate credit allocation in this free market, since it would remove the highest bidders in the targeted industry from the market. This is bad tax policy and would create a dangerous legislative precedent.

Other tax bills would determine tax consequences of a proposed acquisition on the approval or disapproval of the target company's board of directors. This represents questionable tax policy because it is contrary to the determinations of the free marketplace. It would shift the balance between the bidder and target in favor of the management of the targets, although not necessarily in favor of the shareholders. And it could create a situation in which directors would be offered payoffs in retur for approving a deal.

Mr. Chairman, let me address another aspect of this debate that is particularly disturbing to me. I refer to the new vocabulary that has arisen from recent merger activity and the loose definitions given to these buzzwords by several commentators which perpetuate the false notion that mergers and acquisitions are somehow harmful and that participation in these activities is inherently evil. Misuse of these term in a perjorative manner does not serve any purpose other than to contribute to the public's -- and Congress's -- misunderstanding of the true economic motivation behind corporate takeover attempts:

"Greenmail." "Greenmail" is properly defined as the repurchase of a corporation's stock by the corporation from a large shareholder where the same offer to repurchase is not made to all shareholders. I have always been an outspoken opponent of greenmail because by its very definition it discriminates among shareholders, and is thus anti-shareholder. While legislation designed to curb this practice may be well-intentioned, anti-merger tax bills designed to eliminate greenmail miss the mark. I question whether use of the tax code is the best method to adopt to correct what is essentially a securities law matter. But the larger point is that greenmail is a trademark of weak management. The way to end it is not to penalize the shareholder who receives it, as these bill would do, but to focus pressure on the managements who pay it.

"Predator". One should bear in mind the true service that bidders provide to the contest for corporate control. As Martin Peretz's article, "Productive Predators," in the March 25, 1985 edition of The New Republic states:

> "the great grievance against the raiders is that they force management to focus on short-term performance in order to keep share prices up and ward off takeovers. Managers are happy enough to claim bonuses based on short-term performance when it's positive. But more fundamentally, this notion that the stockholders don't really know what's good for them -- and a high share price isn't it -- is exactly the attitude that has given corporate raiders the opportunity they need."

"Liquidator". I frequently have been identified as a "liquidator", though no one has shown me where I have ever liquidated anything. We started Mesa Petroleum Co.'s predecessor company in 1956 with $2,500 paid-in capital. Today we have approximately $4 billion in assets and are the second largest independent oil company in the United States. This record is certainly not that of a "liquidator".

"Junk Bonds". Attempts to deny the deductibility of interest on high yield bonds will not correct the perceived risk of using these instruments in merger transactions. They could result, however, in literally "throwing the baby out with the bath water." As brought out in materials submitted to the House Ways and Means Committee last month, I understand that only abc.. 12 percent of high yield bond issues were used last year in the merger context at all, and that only a de minimis amount was connected with the financing of so-called "hostile" takeover transactions. As I stated previously, the same sector of business that is below the "investment grade" level -- typically the smaller, growth-oriented companies -- is the same sector that historically has provided new jobs for our economy. Restricting the use of high yield bond financing would benefit only the larger companies -- those which can always obtain alternate financing through "traditional" sources, such as banks, and still be entitled to the interest deduction. Thus, the tax bills under consideration would not only chill job creation potential, but also disrupt the basic neutrality of the tax code by discriminating against particular methods of legitimate financing.

"Poison Pills." As Earl W. Foell, Editor-in-Chief of The Christian Science Monitor, said on February 5, 1985, [the poison pill] "may rescue good managers from wasting time keeping predators out of the board room. But it also provides a convenient shield for complacent and inefficient managements."

Unocal has recently issued its own highly conditional poison pill, designed to deprive its shareholders of the opportunity to receive a premium for their shares. Unocal's actions make crystal clear the importance of allowing shareholders to decide for themselves what is in their own best interest -- whether to accept a bidder's real offer or be held hostage by the actions of the target company's entrenched management, whose only real concern is perpetuating their own jobs.

In conclusion, Mr. Chairman, I would like to reiterate three major points:

There is no need for further legislation, particularly tax legislation, to regulate corporate merger activity. Mergers are not motivated by the tax laws or by some kind of quick-profit scheme. They reflect the response of sensible shareholders alert to market changes and problems with management. Mergers are a means by which shareholders exercise the right to run the corporations they rightfully own.

Proposed tax law changes would be pointlessly punitive. Arbitrary legislation of this type can only send a chilling message to the private sector -- that government has lost its sense of cause and effect in the economy and has determined that protecting entrenched management takes precedence over protecting shareholders and our capital markets.

The best defense against a takeover is for management to utilize corporate assets efficiently to maximize the return for shareholders. Legislative tampering through the tax code, which may appear to have superficial appeal, would result in serious harm to shareholders and the economy as a whole.

STATEMENT OF IRWIN L. JACOBS, PRESIDENT AND CHIEF EXECUTIVE OFFICER, JACOBS MANAGEMENT CORP., MINNEAPOLIS, MN

Mr. Jacobs. Thank you, Mr. Chairman. I appreciate the opportunity be here today.

I will, at least for this instance, assume that I was invited here as a so-called raider. At least for the moment I will assume that.

Senator Chafee. That is a pretty safe assumption.

Mr. Jacobs. OK. It's a pretty elite group, too, by the way. [Laughter.]

I would like it clear for the record so that you understand what I really do, and what responsibilities I as an individual have today. I have no formal education; I graduated from high school. I was a peddler at 15 years old, drove a truck until I was 25. Today I have a responsibility for some 40 corporations with some 45,000 employees.

In the process of all of that time and the understandings that I have been able to put together as to what made America great, I think it was a perfect example of my background and allowing me to do what I have done in this world, and to have accumulated the wealth that I have created or accumulated today.

I have heard many statements here this morning that I find—I will say it carefully—almost obnoxious, from the standpoint of people not really knowing the facts but making statements. And what is even scarier is that people should be well prepared for such a hearing as this because of the importance that it has.

I have heard terms such as "shell corporations, dummy corporations, having no net worth, no anything, and raising junk bonds." I can only speak to my example.

In 1981, I took a company over from bankruptcy that has gone in 3 years from 50 cents a share in the stock market to $50 a share. Our volume last year completed was $600 million with a net income of $23 million—I am speaking of Minstar Co., which is publicly held and I am chairman of. And I will say to you that 1 year ago January we raised what is so-called junk bonds—$100 million. Those $100 million of junk bonds had a 46-percent return the first year and converted into equity, not including the yield that they received but just a capital gains, of 46 percent in 1 year.

What I find hard to believe is to sit here and try to understand how some formula can be put together that would unifiably work for the entire system, when we use the term "junk bonds" and should we use ratings such as B's or C's or A's. I thought the American system was based on a record as to what people do and are rewarded for accordingly.

I know my responsibilities as a chairman, and I have heard many people who are chairmen of publicly held companies today say, "What about the responsibilities to our employees and to the towns of which we do business in?" I couldn't agree more with them. But our first responsibility, believe it or not, is to our shareholders. I know I have that responsibility, and I do run a publicly held company. I know by the success of our company that our employees as well as the communities we do business in will be well satisfied if our shareholders are satisfied.

So I have but one objective, and that is to succeed in what I'm doing.

There have been statements made in the past as to short-term objectives versus long-term objectives, and yet I look back and see the entire smokestack industry of this country in the worst state it has ever been in before. I have heard statements that the unions are at fault for this; I absolutely disagree with it. It is that management that so many years ago said, "We are doing things for the future," and gave contracts to the unions that buried them later in time, that what they thought was long-term objectives really turned into short-term objectives.

I have heard the term liquidation in the form of buying companies, closing them down. I don't think that is the case, and I think if you look at every single situation you will find that there are differences between every situation. But I think the redeployment of assets is more the case of a higher and best use of that asset, so that people can enjoy a return on their investment.

If in fact the law that you are suggesting or talking about on the tax law was to be in effect during my last 10 years, there is no question I would not be sitting here today. There is no question that I have done what I've done based on leverage. There is no question that I have been successful. And there is no question that I have paid everybody back.

With that, I would like to close by saying that I always believed in the American system, and I always believed shareholders should have the last word.

Thank you.

Senator CHAFEE. Well, thank you, Mr. Jacobs.

[Mr. Jacobs' written testimony follows:]

April 19, 1985

Hearings Before United States Senate
Subcommittee on Taxation and Debt Management
On the Tax Treatment of Hostile Takeovers

Statement of Irwin L. Jacobs

My name is Irwin L. Jacobs. I am the Chief Executive Officer and principal shareholder in a number of companies, some of them public, in several industries. In recent years, I have led bids to acquire several public companies. In many instances, these bids would be considered hostile, and therefore, I appreciate the opportunities to submit my views, as an experienced participant, on Senate Bills 420, 476 and 632.

Hostile takeovers and threats of hostile takeovers have a positive influence on the economy.

I do not pretend to be an economist, and certainly do not have any formal educational training in the macro economic issues on which there is now ample material to argue the merits and demerits of hostile takeovers. Therefore, I choose to limit my statements to the micro economic arena in which I have personal experience.*/ Hostile takeovers, and the threat of hostile takeovers, have economically benefited shareholders, improved management of those companies taken over, and had a positive influence on managements that have successfully resisted takeovers. Naturally, as in all things, exceptions to this general observation exist, and my participation in the takeover arena as a non-vested, acquisitive entrepreneur has obviously influenced my thinking. However, when I examine economic results of the activity with which I have been associated, the economic benefits clearly prevail.

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*/ I am not addressing the issue of shareholder rights in this paper; however, I have recently expressed my views on the subject in the attached copy of an editorial which appeared in the March 10, 1985 Minneapolis Star and Tribune.

Before commenting on some of the specific observations and experiences I have had in hostile takeovers, I would like to point out the therapeutic and self-correcting influence the free marketplace has on this general field of economic activity. Offensive and defensive techniques utilized in takeovers change through market influences and the court decisions so rapidly that legislative bodies considering the state of balance are almost always outdated. For example, only a year ago target companies complained that the use of the two tier offer unduly pressured shareholders to sell their shares into the first tier of the offer, an act which supposedly then resulted in the second tier shareholders receiving debt and securities of less value than the first tier shareholders.*/ However, in today's fast-moving arena, it is now the target corporation that is using the compensation to be received by the second tier shareholders as a defensive technique which jeopardizes funding for the first tier offer. Obviously, the fact that the techniques used by bidders and target companies are swiftly changing is no reason in and of itself to preclude legislation, but it is substantial cause for Congress to pause to see if the marketplace cannot correct its own abuses before government interference is involved. In this respect, I am generally in agreement with the comments of the economic report of the President, as contained in Chapter 6 and submitted to Congress on February 5, 1985.

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*/As will be discussed later, this is one of the so-called abuses which the subject legislation seeks to remedy.

The marketplace, however, has an additional and more demanding influence. Acquisitions made between parties where an aggressive buyer and a less-than-willing seller (my definition of hostile) must be economically prudent for the acquiror or the economic loss suffered will soon eliminate the acquiror as a participant in future acquisitions. By acquiror I do not necessarily mean the original bidder. The acquiror can be the target company when it purchases shares of its own stock in a greenmail transaction, or when a white knight outbids the original bidder for the privilege of controlling the erstwhile reluctant target.

Those who make hostile takeover bids are frequently characterized prejoratively as avaricious speculators who have nothing but their own personal profit in mind when seeking out a target. The takeover specialist, on the other hand, frequently characterizes himself as a champion of shareholders' rights. For my part, the economic incentive has always been an important ingredient in deciding upon the companies in which I invest. The marketplace insists that the investment decision be based on this criteria, for if my decision is incorrect, the substantial money which I have invested in the transaction could be lost. I do not feel that this activity of investing in companies in which the shares are, in my opinion, undervalued in the marketplace; and if appropriate, making a tender offer for all or a controlling interest in the company, is unproductive speculation. My purchases alone and activities subsequent to the purchases frequently constitute in and of themselves some market correction. If I am incorrect on the value of the underlying values, and thus have overspent for the acquisition, I will soon be treated to the stern reality that the marketplace was more accurate than I. If, on the other hand, I was accurate, I do not see why any profit I should make should be characterized as somehow undeserving. The marketplace demands that I be profitable in this enterprise or I will soon cease to be an acquiror.

Another unique and beneficial aspect of the operation in the U.S. marketplace in permitting hostile takeovers is the swiftness with which market forces come to play. It is my understanding, although not my experience, that other countries will permit market aberations, be they caused by bad management or harsh market influences, to exist far longer than is economically justifiable. Thus, in Western Europe, incumbency is often elevated to something akin to birthright status. Our system permits accountability and recall to penetrate so rapidly that even the entrepreneur who may have started the successful enterprise can be challenged if he no longer operates the business with sufficient regard for the shareholders' rights and interests. Any effort which has the effect of prolonging the time in which managers and the marketplace can be required to be accountable will only promote inefficiency and permit more "speculator" profiteering.

It is not my observation that challenging an existing incumbent management by a proxy fight is a sufficient alternative for producing management accountability. Proxy fights, and more particularly the public aspects of them, tend to be conducted on a very low level of economic sophistication. Certainly the average shareholder has very little opportunity to decide from reading prepared materials which have been diluted by review and censorship from the S.E.C., who is most able to manage the company. Furthermore, since the insurgent group invariably argues that they could manage the company better than the incumbent group, the most powerful argument in favor of this position is that the insurgents demonstrate their comments by purchasing the stock. Furthermore, proxy fights by their very nature are expensive and time consuming, and generally must coincide with the company's annual meeting. Management can orchestrate the timing of this meeting by delaying or adjourning it, and during the course of the contest has total access to all of the relevant information, whereas the insurgent is limited to what information is publicly available. The insurgent must also pay for all the costs of the fight and only gets reimbursement when successful. Management always is reimbursed. This economic force discourages proxy fights and other types of shareholder initiatives. Thus, while waging a proxy fight provides some measure of management accountability, it is not sufficient to be a subsitute for a hostile takeover.

The essence of my endorsement of the need for hostile tender offers is that my first-hand experience with the traditional arguments which favor them are true. I have witnessed slow-moving managements and boards of directors reconstitute their own board and revitalize their management team because of a threat that they would be taken over if they did not do so. I have been involved in situations where management found another suitor or so-called white knight with which to combine in order that it could avoid my effort. In so doing, the judgment of the target company's management and the white knight's management was that the new business combination was better than the one I proposed. While I do not comment on whether my proposal would have been better or worse for the company, I do know that the new enterprises frequently operate more profitably than before, and shareholders have recognized higher values for their stock.*/ I have been successful in acquiring companies through the use of a hostile tender offer, or in competing bids where mine was not the most favored. After acquisition, my organization has been responsible for effecting numerous changes in the operations. This has included some asset dispositions as well as new management assignments and personnel. I believe that these realignments have effected efficiencies. As mentioned above, if I am wrong on this, the marketplace will soon penalize me for my mistakes. So far, my management has permitted me to continue to pursue further business combinations.

S.420, 417 and 632 should not be adopted.

This leads me to comment on the legislation which is currently under consideration by this Committee. I recognize that certain abuses exist with respect to techniques or tactics used in hostile takeovers, but I believe such abuses are instigated most often by targets. If further regulation is warranted, any such regulation must be balanced. The current proposed regulation is decidedly hostile to hostile takeovers; and if adopted, would have a dramatic and decidedly deadening effect on this now viable and positive economic activity.

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*/In these instances, it is frequently true that some assets of the newly combined company are sold to finance the business combination, but these assets presumably are those which have the least synergism with the new company, or have a peculiarly high value to another buyer. Thus, I do not believe it is fair to label this combination a "bustup" merger.

Proponents of the new legislation suggest that by allowing deductibility of interest expense incurred in takeovers, federal tax policy somehow favors the hostile takeover. This simply is not true. Federal tax policy is now neutral on the activity, and the new legislation would penalize it. There is currently on the books tax legislation which treats debt as equity when the facts and circumstances uniformly applied suggest that it be so treated. The new proposed legislation, however, would provide that disinterested members of the board of directors may determine that the takeover is hostile, and thus the debt is converted to equity.*/ The effect of putting so powerful an economic weapon in the hands of the incumbents is tantamount to putting absolute control of the situation in their hands. Because, as indicated above, I believe hostile takeovers serve a useful purpose, I am opposed to this result.

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*/ Management is not adverse to using "junk bonds" as financing when it suits its own purposes. I first learned of this type of financing when management proposed to use it as a defensive tactic in a management sponsored two-tier tender offer in opposition to my all cash offer.

On the further issue of the tax treatment of greenmail payments, I am generally opposed to the use of such a device by management. However, the marketplace seems to be adequately covering the problem, and now many commentators believe that greenmail may well be a passe defensive tactic. Moreover, it is simply one of many techniques employed by management in fending off an unwanted suitor. Singling it out as such an egregious economic ill improperly emphasizes it against the background of the numerous other techniques. And I am not sure that greenmail is susceptible to such easy definition. Management buybacks can take many forms. Accordingly, I do not believe that attacking this problem by tax legislation is the proper or balanced method of approaching this issue.

Summary

I believe that hostile takeovers serve an important management monitoring function in our society. Abuses do exist by both sides. Any legislation designed to remedy these abuses should take into account the extreme vitality of the marketplace in providing its own remedy and the fact that government regulations should not produce an imbalance in the overall ability of one side or the other to prevail. The subject legislation would have the effect of producing just such an imbalance, and accordingly, I oppose its adoption.

Thank you.

[illegible] Tribune Sunday [illegible]

Anti-takeover law favors managers over shareholders

By Irwin L. Jacobs

With its new anti-takeover legislation, Minnesota has added to its reputation as an over-regulated state, biased against business. In a widely published article (Commentary, March 3), William C. Norris, chairman of Control Data Corp., endorsed the Minnesota anti-takeover statute as a model for the federal government. His article is a classic example of the "divine right of kings" attitude that prevails in many corporate ivory towers throughout this country.

Beginning with the opening paragraph, wherein Norris refers to Control Data as "my company," to the last paragraph — "Anyone who tries to take over Control Data will be in for a world class fight" — the article exemplifies disdain by corporate officers of publicly held American corporations for their shareholders.

As chief executive officer of a public corporation, I have always assumed that I am an employee of that corporation and that the corporation is owned by its shareholders, to whom I am responsible. Corporate executives who subscribe to Norris's views seem to be saying that it's O.K. to sell stock in the corporation to the public, but after the sale, shareholders should not be heard from again, that corporate management has an absolute right of self perpetuation, and that corporate management is not answerable to its shareholders.

Norris endorses and advocates legislation that will further insulate corporate managers from accountability. Is there any question that the primary constituency of a publicly held business corporation is its shareholders? Is there any question that when a constituency is disavowed, it should have the right to remove its elected representatives from office? Why should the Legislature be invited to stifle or restrict competitive bidding for publicly traded securities?

Our political democracy works well because it abides by a fair election process, and elected political leaders understand that they must represent their constituency in order to remain in office. Is there anyone who really doubts that corporate democracy should work in much the same fashion?

The facts are, however, that when corporate managers and directors have been confronted by dissident shareholders or a "hostile" tender offer, they have frustrated the dissident or tender offeror by such means as issuing additional shares (votes) to friends, postponing the election or voting themselves large bonuses if they lose. Such actions by our political leaders would be unthinkable, and yet, until recently, such actions by public corporation managers have gone unchallenged.

There are signs that shareholders are beginning to examine more closely chicanery by corporate managers. Institutional investors, who themselves are responsible to a shareholder constituency, are more acutely focusing on the management of corporations in which they hold voting securities and are beginning to realize that corporate managers can be held accountable to their shareholders. Witness the recent rejection of the self-serving management recapitalization plan proposed by Phillips management.

A public-fund investment council has been formed by state and municipal investors who will now meet to discuss and judge whether particular corporate managers are acting in the best interests of shareholders. Institutional investors are no longer routinely sending management proxies to vote for placing so-called "shark repellants" into the articles and bylaws of corporations.

Shareholders have also witnessed events that a few years ago would have seemed impossible. For example, the management of Walt Disney Productions, Inc., after engaging in several schemes to protect its controlling influence over the corporation, found that several shareholder groups could exert enough pressure to cause management to abort a speculative and overpriced acquisition of Gibson Greeting Card Co. and, further, to cause a complete change in senior management of Disney. All this has benefited the corporation, its shareholders and employees. But these examples of shareholder democracy at work are still too rare.

There must be a balancing of the interests in any contest for control of a corporation; however, the new Minnesota legislation unilaterally entrenches current management and stifles competition.

Proponents of the Minnesota anti-takeover law assert that its passage will improve Minnesota's business climate by freeing corporate managers to get down to business, unburdened by concerns of takeover. Proponents also assert that tender offers are inherently bad. But tender offers are rarely made for well-managed companies; most are for poorly managed corporations in which bidders seek to make a profit on the corporation's unrealized potential. The stock of well-managed companies, even though from time to time undervalued in the marketplace, tends to trade at prices closer to the true value of a corporation, and most certainly reflects the level of shareholder confidence in its management.

Significant benefits flow from a tender offer to acquire a poorly run company. Shareholders who sell their stock generally receive a premium over the current market for their shares; non-tendering shareholders generally find that their shares have increased in value because of fresh business strategies and increased efficiencies in the company's operations. Employees who remain after a takeover benefit because the business will be more competitive, and thus they have better long-term job security.

Who stands to gain from the anti-takeover legislation? Certainly not the shareholders who need all the help they can get in attempting to hold management accountable for their actions. The only beneficiaries are the insecure corporate managers who resent and fight bitterly against scrutiny from their true constituents, the shareholders. Corporate managers, instead of fostering and endorsing legislation to further insulate themselves from accountability, should be directing their efforts toward their true responsibility: managing the corporation for the benefit of its shareholders.

Irwin L. Jacobs is chairman of the board and chief executive officer of Minstar, Inc.

Senator **Chafee**. You talk about shareholders. But what about these situations where raiders go into a corporation and then get bought out through greenmail? The shareholders of a corporation certainly don't benefit from that; it is a management decision. But the raider certainly comes off very nicely. I can't see how anybody benefits except the raider. Do you think that the suggestion that there be no deductibility of the greenmail expenses or the premium that is paid should be in the code?

Mr. **Jacobs**. Let me answer that two ways to you. First of all, I don't believe in greenmail. And although I have been associated with it in many, many places, I will tell you here today that I have never sold greenmail in my life.

I don't know who you can blame other than management for paying greenmail. I have never heard anybody in my life saying, "You're paying me too much money. Pay me less." And how do you sit there, if it's the greenmailer or whoever you are speaking about who takes the position, "I don't want greenmail," but he actually gets blackmailed into what he is doing? And how many times have we heard where the company in fact has told the so-called greenmailer, "We will deliver you the bones of this company if you don't sell out to us"? I think that's clear on the record. But I don't agree with greenmail, by the way.

Senator **Chafee**. Do you mean you have never taken greenmail?

Mr. **Jacobs**. That is correct.

Senator **Chafee**. What are your thoughts on it, Mr. Pickens?

Mr. **Pickens**. I have never taken greenmail; I have never even negotiated greenmail with the management of a company. I have had many opportunities to take greenmail. In the Gulf deal we had that opportunity, in the Phillips deal we had that opportunity several times to do it. We turned it down.

I am opposed to greenmail. But again, the only reason you have it is because you have weak management. I can't believe, as Mobil did, a company needs to have a special stockholders meeting to vote against greenmail. Well, the board of directors, all they have to do is just say, "We're not going to pay greenmail." That's all. You don't have to have a special stockholders meeting. Why have that cost on the stockholders? Just give a declaration that, "We're not going to pay greenmail," and that will take care of it.

Senator **Chafee**. I thought you received some greenmail out of that Phillips deal?

Mr. **Pickens**. No, sir.

Senator **Chafee**. Is that correct?

Mr. **Pickens**. We did not. All the stockholders got the same offer—the reason why we got $50 in the confusion over greenmail was that we were not paid until the deal was over with at $53. The Phillips management and the board of directors and their two investment bankers, if you will read their press release, said that all stockholders would receive $53. So there was no premium—had we wanted to greenmail it, Mr. Chafee, let me tell you it would have been a lot different than $53.

Senator **Chafee**. What about the argument that we will hear later and that has been made that under this current furor and ploy of raiding on corporations, that management now is spending all of its time looking over its shoulder instead of being prepared for the future in the forms of investments to produce a better product—a better mousetrap or a better computer, whatever it might be—that now management is spending its time in defensive maneuvers or increasing the payouts of its stock, of dividends, rather than planning for the long haul? What do you think about that?

Mr. PICKENS. Is that my question?

Senator CHAFEE. Yes.

Mr. PICKENS. My feeling about that is that that is nothing more than a defense by weak management. Had managements done a good job, they would not be vulnerable. Companies that prepare for the long term also prepare for the short term.

In the case of Mesa Petroleum, we sell at 100 percent of appraised value. The 10 largest oil companies in the United States sell at 45 percent of appraised value as an average. Something is wrong here.

As far as talking about them looking over their shoulder or their having to direct themselves to defenses and all, I say that you are probably getting them back to work where they should have been in the first place.

Senator CHAFEE. How about you, Mr. Jacobs. What do you say to that?

Mr. JACOBS. I can't imagine why anybody would sit there and worry about a defense tactic when they have so many things to do, as you just suggested. What is the rationale for it? Who are they afraid of and what are they afraid of? That someone is going to take them over, throw them out? I mean, the insecurity—I have publicly stated there have been people who have bought reporting interest in our publicly held company. I said we have a very open door policy. If anybody wants to come forth and thinks they can do a better job than we are doing, pay the right price for it, more power to them; I'll step aside any day they wish. That is a responsibility. What gives these people——

I'll tell you what is even more amazing to me than even that: These are people who are the largest-paid individuals in America today, the people we are talking about that run these companies. And yet what is unbelievable to me is when you look at the ownership that they have in their own companies. Embarrassing enough, a chairman who is making $1 million a year could have as little as 1,000 or 5,000 shares of stock. I find that as big an insult as anything you could possibly do to a shareholder. Now, that is more the rule than the exception.

Now, why should they be spending their time? Well, for the obvious reason: They don't believe in their own company based on their investment, so they are interested in holding on to that job—that's the reason for doing it. They don't deserve to.

Mr. PICKENS. May I add further to that?

Senator CHAFEE. Yes.

Mr. PICKENS. The worst case of all was when Royal Dutch Shell took over Shell Oil Co. Two of the directors of Shell Oil Co. have zero shares. They didn't even think enough of the company to buy 10 shares of stock in it.

If you take the Business Roundtable, which is the 200 largest corporations in America, the managements of those companies own less than one-three hundreth of 1 percent of the companies but their average salaries are over $1 million a year. Now, they've got a conflict of interest going in in that situation, for sure.

Senator CHAFEE. Senator Long.

Senator LONG. No questions, Mr. Chairman.

Senator CHAFEE. Senator Bentsen.

Senator BENTSEN. Well, first, Mr. Pickens, it is nice to have a witness who speaks without an accent. [Laughter.]

A lot of testimony here about junk bonds, high-yield bonds, and some problems that might result therefrom. Then they were talking about trying to draw lines and limitations. Are there any limitations that you can see as feasible on the issues of junk bonds? Mr. Pickens first, and then Mr. Jacobs.

Mr. PICKENS. May I read a piece out of my statement on that, just to give some statistics? It will be brief.

Senator BENTSEN. All right.

Mr. PICKENS. A Wharton study showed that junk bonds have produced almost double the rate of return of AAA rated bonds. And the reason that the yield is high is because they are riskier investments. Even so, the junk bond defaults have been low.

New York University Professor Edward Altman found that from 1974 to 1984 an average of 1.5 percent of outstanding high-yield bonds defaulted annually. That compares with a default rate for all corporate bonds of only 0.088 percent. In addition, companies rated "less than investment grade" created at least 80 percent of all the jobs in America since 1965.

So I don't see the fear that some people see in junk bond financing. I think it is a legitimate form of financing.

Senator BENTSEN. Do you have anything further to add to that, Mr. Jacobs?

Mr. JACOBS. Well, I think, first of all, the assumption of using the term "junk bond" assumes that no one is looking after this investment, and someone is just standing there waiting to be handed some money. I can tell you firsthand that we have sold what is so-called "junk bonds," and there is a due diligence, and there is much time spent on that. In conjunction with that, there is an equity base that goes behind junk bonds, which in fact puts the shareholder at risk before that junk bond, so to speak, is put at rest.

Senator BENTSEN. So you think disclosure takes care of it?

Mr. JACOBS. Absolutely.

Senator BENTSEN. Let me ask another one, though we have a limited time here.

I am deeply concerned about what has happened to our balance of trade, looking at a $123 billion deficit, and after we look at the first quarter it looks like it may be $160 billion. So I am concerned about our companies having enough capital; concerned about capital formation, concerned about being able to bring about the advances in technology to meet this kind of competition.

What do you think is the net result of these kinds of acquisitions and mergers? Do we add to the challenge to meet that, or is it diminished? Mr. Pickens.

Mr. PICKENS. If you will look at Kenneth Lynn's report to Chairman Shad of the SEC as far as research and development is concerned, he sees no concern about this as far as a reduction in R&D expenditures.

I don't see any problem here either, because in the companies that we have been involved in, that R&D is a somewhat insignificant factor compared to the overall size of the company and their total budget.

Now, I think a remark was made here earlier this morning about the $100 million Unocal used for R&D. Their budget is over $2 billion a year. I do not see that as a threat.

Senator BENTSEN. Mr. Jacobs.

Mr. JACOBS. No, I would just have to generalize and say that to say what this does to the import-export theory, and that is what you are referring to, I cannot find an avenue at all.

But I must say to you that you can't just generalize and say everything goes one way or the other. I am sure you could find some examples to substantiate the scenario which ever way you wished to go. But on balance, I don't see that. As a matter of fact, I would assume that it would help in the long term, only because it is making it better based on consolidations. We have overproduced in this country, plain and simple. You can't have four gas stations on every corner and six supermarkets on every block. It doesn't work.

Senator BENTSEN. I see my time has expired. Thank you, Mr. Chairman.

Senator CHAFEE. Thank you.

Mr. Pickens, what about the shareholder in a restructuring in a company that has got debt right up to the hilt, and now the shareholders are left there, the 49 percent or whatever they are, that haven't gotten the benefit of the buyout? Doesn't that shareholder face a riskier investment than he would have before the whole business started?

Mr. PICKENS. Mr. Chairman, could you give me the name of the company you are talking about?

Senator CHAFEE. I am taking "an" illustration, an example of the restructuring where there is a massive amount of debt.

Well, I don't know the details of the Phillips situation, but they all didn't get out of that with something; some of them were left there.

Mr. PICKENS. No, that's not right, Mr. Chairman. The Phillips deal was a restructuring that took on about 4.5 to 5 billion dollars' worth of debt for the company. The company has a cash-flow of about $2.5 billion. If you look back over the investment record of the Phillips management for the last 10 years, it's been a sad one.

Senator CHAFEE. It's been what?

Mr. PICKENS. It's been sad. The results have been poor. The cash flow has been put to poor use.

What has happened—and I have to refer back to the primary asset to the stockholders, which is the reserve base for oil and gas. And the Phillips reserve base for oil and gas has not been replenished for a number of years, at least 5. That is a sad commentary on that particular management.

Now, what happened at Phillips in the restructuring is, the company actually took on debt and transferred values to the owners, the stockholders of the company. There was not anybody left out in the Phillips deal unless they were unsophisticated and didn't know to turn in their stock to get the $60-a-share value on half of the stock, and then they would have the remaining stock sent back to them which trades at a price of about $40 a share.

Now, if somebody was so unsophisticated that they didn't send their stock in after the management told them that they were turning their stock in—the ESOP plan told them they were turning their stock in, and they made individual calls to all of the stockholders as directed by the SEC—if they didn't turn it in then, that is sad. But I believe about 96 percent turned it in. So, there were some few that did not.

The company stock would bring about a $35 price in the marketplace today. And with the combination of the two pieces of paper, the price is somewhere over $50 a share. So, you had about a 15 point enhancement for all the stockholders there, and you also doused—you know, the CEO of Phillips is on record in the New York Times saying, "Give the devil his due." I think I was the devil, that he did make us do some things that we should have done sooner and to a larger extent we will be a more efficient and better run company. And that was paraphrasing some of the things he said.

But the stockholders came out very well. And let me quantify that: About $15 a share at least over and above the pure company price had they been left alone and not restructured, which was 160-70 million shares outstanding. So, you are talking about over a $2 billion enhancement in value, which would have gotten the Federal Government probably somewhere around $400 to $500 million in taxes.

Senator CHAFEE. Well, let me just say this. It seems to me when these takeovers are over, when all is said and done, there is a lot of consolidation. I guess it really came home to me when I saw the picture in the New York Times—or was it the Wall Street Journal?—of the Capital Building, the headquarters for Gulf in Pittsburgh, up for sale. And there is a company that had gone along for many, many years. And out of this, many people lost their jobs.

I am not talking about corporate management making hundreds of thousands of dollars in salary and owning no shares of the company; I am talking about the workers down at the bottom of the heap.

I couldn't look at that without thinking, "Is this really good?"

Now, I know that Mr. Jacobs or you have pointed out that smokestack America has collapsed and a lot of jobs have disappeared, some have suggested through bad management; but I am setting that aside. These are companies who were going along satisfactorily, and suddenly something takes place and out go a lot of workers.

What is your answer to that? That is just the shareholders prospering, and that's America at its best? What about that, Mr. Jacobs?

Mr. JACOBS. No; I don't think there is any question, that's tough to do and hard to take. No question about it. So I wouldn't sit here for a minute and tell you there is anything wonderful about seeing a corporate headquarters shut down. But I don't know how you can set aside the statement that I made earlier—that you said, "Let's put that aside for a moment"—about what happened to the smokestack industry.

Now, if somebody would have told you 50 years ago or 40 years ago what was going to happen to the steel industry in this country, you'd say it's impossible, there is no way it could happen.

Sometimes we don't have the foresight necessary to see those things happen. Fortunately, some people do. And that is where consolidation takes place to make something better.

Now, everything that happens doesn't create good for all and bad for all, and yet you have to balance that based on what the net result is. What does the public get served out of it? What ultimately happens?

I think the people that bought Gulf are very sophisticated in the world, and their track record speaks for itself. I don't think you can just take a situation without taking the whole picture.

And putting aside what happened to the steel industry, look what happened to the automotive industry. They woke up an inch short of their life. It pretty near was over for them, too. Fortunately, they were able to make it happen in time, and the Government was there to take care of Chrysler. Otherwise, what would we have had there? What would we be talking about today?

I can tell you, I looked to go buy a business from Chrysler prior to Mr. Iacocca coming to Chrysler, a small company. And I sat down at that time with the chairman of that company, and when I finished talking to him and heard the things he told me about how he wanted to sell that business, I said to myself there was no way that this company could ever, ever make it. And I don't know how they got where they got. I wouldn't even sit here and embarrass you or anybody else as to what these people said to us, why and how they wanted to sell this company. Now, had they been there I will assure you there would be no Chrysler today. You can thank Mr. Iacocca for that.

So, I don't think you can just pick a situation without looking at the total picture and saying that maybe what is happening is preventing such as what happened to the smokestack industry and the automotive industry and many industries in this country—massively overproduced.

Senator **Chafee**. Well, you listened to the testimony of Senator Brady here earlier on the subject of junk bonds—and I will address this to both of you—his deep concern about the effect it could have on the financial stability of the country in the future. And he recommended that we have a moratorium.

Now, I know your answer is qoing to be that we shouldn't have a moratorium, but what about the concerns he raised?

Mr. **Jacobs**. Well, I find it interesting that here he represents Unocal and it would just be very convenient to have a moratorium right now, just to handle the Unocal situation is what I would assume. He didn't say, "Let's stop it," he just said, "Let's take care of it right now." He didn't give any answers, as far as I'm concerned. I heard what he said; I was here for every word of it. He didn't say we should discontinue it. He didn't even have an answer to the system.

I don't know Mr. Brady. I have never met him in my life. But I found it interesting that here is a man who is in the industry, who came here, knows what this is all about, and surely didn't come with any answers. All he said was, "Please give us a moratorium"—"we" meaning Unocal. I didn't see anything else come out of that statement. He couldn't even give you a direction in which to move.

Mr. PICKENS. I know Mr. Brady. He's a good investment banker, and he's a very good golfer. He's got about 10 bucks of mine from the last time I played with him.

But Mr. Brady's firm, Dillon & Read, solicited our business in the Phillips Petroleum Co. deal, which I find to be interesting as to some of his testimony here.

But second, if you take Dillon & Read's and Goldman-Sachs' fees working for Unocal, they get $3 million that they have already received; and they get $5.5 million for every 90 days that Unocal remains independent. For every 90 days they can keep it independent up to 1 year they get $5.5 million—the cash register rings. And they get $3 million for every dollar above $54 up to $19 million if Unocal is sold. But the interesting analysis is, if Unocal is not sold, the bankers can make more money than if it is sold at any price; it doesn't make any difference. If it is not sold, they make more than if it was sold for $100 a share. I find that to be interesting.

And I found I was in agreement with some of Mr. Brady's comments; a lot of it I was not in agreement on. But moratoriums for stockholders are terribly damaging to him.

Mr. JACOBS. Well, in his particular case it is quite rewarding.

Mr. PICKENS. It is, yes.

Senator CHAFEE. Now, before you go any further, let me just say this: I think all of us on this bench know Mr. Brady and know that he did not come here just to defend Unocal. And he made it clear that his company would benefit from this whole business, but he himself said he was opposed to the whole theory of it, the junk bonds; that is, and that it had nothing to do with Unocal. He clearly said that they were going to make money on it—had made money, would make money. So, I resist the suggestion that Senator Brady came here just to protect Unocal.

Mr. JACOBS. I won't make that statement.

Mr. PICKENS. I did not make that statement, either. But I just point out that the fees are substantial. [Laughter.]

Mr. Chafee, if I could, let me comment on the Gulf deal, please, because I was very much involved in that, as you well know.

Senator CHAFEE. You certainly were involved with it. I read the description of it.

Mr. PICKENS. Yes; and your description of the building and the sale of the building and the loss of jobs in Pittsburgh.

We gave the Gulf management four options. One was that we would take over and run the company. I believe in this very room that Mr. Lee made the statement that, "If you don't allow us to go to Chevron, Pickens will take us over." And I think that was exactly right, because I think the stockholders were fed up with management and were going to vote with us. We said if that took place we would move to Pittsburgh and keep the headquarters there.

Second, they could have done the deal with KKR in a leveraged buyout at $87.50, which was over a billion dollars more to their stockholders, and kept the headquarters in Pittsburgh.

The third was, and the first offer that we made to them was, "Do a royalty trust and share some of the cash-flow with the stockholders, and we will go away," and they would have left the company in Pittsburgh.

The fourth one is the one that the management and the board of directors of Gulf took. They took the deal with Chevron and therein lost the headquarters in Pittsburgh.

Now, I find it to be interesting, and I don't know if you recall how many employees Gulf had in Pittsburgh. They had 2,100, is what they had—750 in the downtown office and the balance in the research center out in the suburbs. But also in Pennsylvania you had 25,000 stockholders, and those people owned 20 million shares of stock. Had Gulf not sold out to Chevron for $80 a share, I don't believe that the stock could ever have gone above $40 again, because the company had not replaced their reserves for 12 straight years. So therein were 40 points made by 25,000 stockholders, which was $800 million, which was about—it would be about one-sixteenth, I guess, of the total amount made in that particular transaction by all of the stockholders of Gulf Oil, which was about $7 billion.

Senator CHAFEE. In other words, you did a big favor for the citizens of Pennsylvania?

Mr. PICKENS. There's no doubt that we did a big favor for the Gulf stockholders, and there were 25,000 of them who lived in Pennsylvania.

Senator CHAFEE. Without getting into the specifics of one company or another, it seems to me here is one of our concerns: What happens to the creditors if for some reason these high-stake dealings with these high-yield bonds, if it doesn't work out? In other words, if the deal doesn't go through, then what kind of disruptions would take place in the credit markets as a consequence?

Mr. PICKENS. I'm confused; would you repeat that?

Senator CHAFEE. Say the deal does go through. Let's just take the Union Oil situation without going into every detail of it. As I understand, NUCO's sole purpose for existence is to buy the Union Oil stock with $2.4 billion collected in large part through the sale of these securities, call them junk bonds if you will.

Now, it appears that the only collateral that NUCO creditors will have is the Union stock purchased through the tender offer. Is that correct?

Mr. PICKENS. No.

Senator CHAFEE. Well, all right, my assumption is wrong.

Mr. PICKENS. Yes, it is. We'll have $1,700 million of Mesa's money in ahead of all other money. So if anybody loses in the Unocal deal by going with us, we will have lost $1,700 million before they lose a dime.

Senator CHAFEE. All right, so you will have lost. Now, what happens to the creditors if for some reason the value of the stock falls dramatically? What kinds of disruptions are going to take place then?

Mr. PICKENS. When what stock falls dramatically?

Senator CHAFEE. The Unocal stock.

Mr. PICKENS. Well, see, we'll take the Unocal stockholders out; there will be no Unocal stock. In the transaction we have, we'll take it out at $54 a share. So all the Unocal stockholders will get—they will all receive $54 a share.

Senator **Chafee**. So you see no problems with this whole deal?

Mr. **Pickens**. Absolutely not, none.

Mr. **Jacobs**. Nor do we. We put $100 million in there.

Mr. **Pickens**. We raised $3 billion for that transaction in 4½ days. Somebody looked at it closely; you don't have people just running up to finance $3 billion worth of securities like that unless there is some real guts in the deal.

Senator **Chafee**. Senator Long.

Senator **Long**. I would like to get things straight. How much will the shareholders of Unocal get?

Mr. **Pickens**. They will get $54, Mr. Long. Yes.

Senator **Long**. What is Unocal selling for now, Mr. Pickens?

Mr. **Pickens**. On Mr. Hartley's testimony the other day over at House Ways and Means, he said it was a $35 to $37 stock. Friday I think it closed at about $48.

Senator **Long**. So the stock has been moving up since you made an offer?

Mr. **Pickens**. Yes, it has.

Senator **Long**. According to your view, junk bonds really have not been a bad deal at all. Would you mind telling me about the study that you have on that?

Mr. **Pickens**. The Wharton study—Wharton School of Business—showed that junk bonds have produced almost double the rate of return as AAA rated bonds. And the other study was by Professor Altman at New York University who found that from 1974 to 1984 an average of 1.5 percent of outstanding high yield or junk bonds defaulted annually, and that compares with a default rate of all corporate bonds of 0.08 percent. So they have a good history, yes.

Senator **Long**. I would appreciate it if you would make that study available to our staff, because that is at variance with what I have been led to believe.

Mr. **Pickens**. Another statistic you might be interested in is that there are only 15 percent of the public-owned companies in the United States that qualify for investment grade bonds. Those are the Fortune 500 companies, so to speak. And 85 percent do not qualify. But over the period 1965 to 1985, there were actually 38 million jobs created in America. Now, where did those jobs come from? The top 500 or the investment-grade-bond companies actually lost 3 million jobs, and the 85 percent that were not investment grade created 38 million jobs, for a net increase in jobs of 35 million. So you can identify where those jobs are coming from, because that 85 percent, that is the entrepreneurial part of corporate America, is what it is.

Senator **Long**. Well, that goes back to the question I asked at the beginning of this hearing—how do you go about define junk bonds?

I have known some people in life, who have had a way of dealing where they give you a piece of paper that has a big figure on it but winds up being valueless. That is not what we are talking about here when we talk about junk bonds; apparently, we are talking about something that, from the point of view of someone on Wall Street, has some credibility.

Mr. PICKENS. I don't think there is any doubt about that. The largest dealer in junk bonds is Drexel-Burnham. But you also have junk bond departments at Morgan-Stanley, First Boston, Merrill Lynch, and down the list you go. This isn't some kind of hokum deal, that people are out here selling these things in the back alleys or someplace else. These are deals that are looked at very closely by investment bankers.

Senator LONG. so I take it we are talking about something here that is described as a junk bond, but at the same time we are talking about a piece of paper that a lot of good business people think will be paid at full face value with interest.

Mr. PICKENS. Right.

Well, some of the biggest buyers of junk bonds are the IBM Pension Fund, and Prudential Insurance Co., and Proctor & Gamble pension funds. These people are looking at these situations very closely. They are not just going into deals shooting from the hip.

Senator LONG. In other words, the loss ratio is high but the return is high enough, presumably, to justify taking the risk?

Mr. PICKENS. Exactly.

Senator LONG. Well, thank you very much.

Senator CHAFEE. Senator Pryor.

Senator PRYOR. Mr. Chairman, I think this is almost as complicated as Star Wars. This is extremely complicated for us. I think that you must be realizing that we, as the people's elected spokesmen up here in this city, must be aware of not only the stockholders but also of good business practices, protection for investors, et cetera. We also must be very sensitive to relocation or dislocation of businesses.

In the Phillips case, Mr. Pickens, it was my understanding that, had your acquisition taken place and had you been totally successful, that there was no guarantee that Phillips would still have been based, for example, in Bartlesville, OK.

I am wondering what factoring you put into your consideration of this as it related to the employees of the Phillips Petroleum Co. that had been there for a good number of years in Oklahoma. On a scale of 1 to 10, where do they—you have talked about the stockholders, and were very critical of management. Where do you come down on the employees?

Mr. PICKENS. Well, Mr. Pryor, I can give you public statements that I made on probably at least 20 occasions that we would move to Bartlesville—my wife is sitting in the back of the room and she can verify this for you—we would move to Bartlesville and live there and run the company from there.

Now, my wife is a native Oklahoman from Atoka, and I am a native Oklahoman from Holdenville. She went to the other university in Oklahoma, which was OU, and I went to Oklahoma State University. But we both have roots in Oklahoma, and we were verv sincere in what we were doing. In fact, we saw accumulations in the Phillips stock well before we ever bought the stock, and felt like that something would happen to that company. And we felt like that company would be moved out of Oklahoma.

We went in and took that position in the Phillips stock and offered up two options to the Phillips management. One was, "Leave the company in Bartlesville, and you run it," or "We will move to

Bartlesville and we'll run it." And both of us would do a $60 leverage buyout. And they would not do that deal. But we did not want that company to leave Oklahoma.

I talked to Governor Nye about it. I talked to both Oklahoma Senators about it. I talked to Congressmen in Oklahoma about it. And I told them that we had no idea of moving that company out of Oklahoma and did not want it to leave Oklahoma.

As far as the employees are concerned, the employees in any company are going to do well if the company does well. If the shareholders prosper, the employees will do well. And if you look back over my record with employees, it's an unusual record, I can tell you that. I have great rapport with the employees, great comraderie within the company, and I would say it's the best morale of any company I know of in the oil industry.

Senator PRYOR. I have seen reports alleging you made or what your company made, as a result of your attempt to take over Phillips. What were the figures on that?

Mr. PICKENS. Well, let's go back to the total amount that all the stockholders made at Phillips. It was 15 points on about 160 million shares. And that would be $2.4 billion. Our part of that as their largest stockholder, we made $80 million.

Senator PRYOR. You made $80 million on it?

Mr. PICKENS. Out of the $2.4 billion, yes.

Senator PRYOR. Well, are you better off or worse off for having not succeeded?

Mr. PICKENS. Oh, we wanted very much to take over the company, and we would have looked forward to moving back to Oklahoma and running Phillips Petroleum.

I used to work for Phillips. I worked for them from 1951 to 1955, and we wanted to take over the company and run it. We were sincere about it.

Senator PRYOR. Well, this $80 million, where would that $80 million have gone otherwise had vou not left with it, so to speak, or had you not made that profit?

Mr. PICKENS. Well, don't be confused that this was an $80 million check that they wrote out to us; they wrote out many checks for $2.4 billion. Ours happened to be one of those checks. What they did is, they transferred value from the company to the stockholders, the stockholders owning the company. So all of the stockholders prospered to the same amount, percentagewise. So there was nothing here that was left out.

The Phillips people are on record here in testimony that I have seen or heard here in Washington, whereby they say that their budget will remain the same.

Senator PRYOR. But, was this not money that would have been put let's say, into research and development or further exploration, or let's say adding to the present facility there in Bartlesville? Was this money that was so-called drained out that can no longer be utilized for capital expansion?

Mr. PICKENS. Well, when you say drained out, remember the stockholders own the company. So I don't know, but anything going to stockholders or to the owners, I don't identify that as a drain out.

I did say that Douse is on record—their chairman here in Wash-
gton—as saying their budget would not be reduced.

Senator PRYOR. I see my time is up. Thank you.

Senator CHAFEE. Senator Bentsen.

Senator BENTSEN. Mr. Chairman, I think these hearings have
en very productive and very informative. I thank these wit-
sses, too.

As for you, Mr. Jacobs, if you haven't back to your high school
union, you ought to go. [Laughter.]

Mr. JACOBS. I have gone to every one.

Senator CHAFEE. Do you consider this business of this takeover
ania that is going forward now to be just temporary? Do you
ink something has happened? Or do you foresee this going on in
e future? Mr. Jacobs.

Mr. JACOBS. I see really two things happening. I think there are
lot of people who are starting to identify that consolidation is im-
rtant from a competitive point of view for the whole world, not
st for the United States but for the world, to compete in the mar-
ts that we used to compete in and find it difficult today. We have
erproduced in this country.

And everything doesn't start out at the top; everything works to
me gradual point. Maybe there is a consolidation that comes
ck, it stops. I don't think there is any question that interest rates
ave a lot to do with it.

You know, I have been in this business—as you identify it—now
nce 1976. It just seems like it is much more aware today than it
as back in 1976–77. But I will tell you that it is not all bad, and it
not all good, because nothing works that way. On balance, I
ould say it is much better than it is worse, or bad.

Senator CHAFEE. Do you think the attempted cure might be
orse than the illness?

Mr. JACOBS. Well, I don't think there is any question that what I
n hearing is being attempted to be done would devastate—I
ean, it is tantamount to nationalizing your companies and closing
own the stock market; basically that is what you are saying.

You know, there is a statistic. I do not have it here, but I will tell
u there are more leveraged buyouts, as you would consider not
stile, by a great margin than there are hostile. And I will tell
u that many of those leveraged buyouts that are not hostile were
eated because of the hostile atmosphere and created a competi-
ve market for management or whoever bought it, because in
any cases management is buying the businesses. What gives that
oup the right to say, "It is friendly to us but unfriendly to you,
r. Jacobs, so we can have the tax deduction and you can't"? We
n't buy these businesses to bring a ball and hammer and then
ose them down; we believe in running and running them well.

So I don't see the system in any way, shape, or form, based on
hat I know today, breaking down as to where we are going. But I
rely would see a great deal of danger with some of the ideas that
see being put forward.

Senator CHAFEE. All right.

Finally, Mr. Pickens, Senator Domenici gave some testimony
ere as follows:

Gulf Oil, bought by Chevron, has recently closed its Pittsburgh research facility. Phillips, which incurred massive debt in its takeover battles, has laid off research personnel and cut its capital research effort by 75 percent. Phillips' research efforts into Robotics has ended. Both companies have withdrawn research grants from MIT, University of Texas, and so forth.

The question is, what will happen to the $125 million a year that Unocal spends in research and development when the siege of its corporate structure is over with?

Well, going through all of this testimony—Senator Brady's and others—is a threat. And that threat says, "How are we going to have more oil in the future if we are not going to continue this research and development and exploration" which these companies are curtailing after going through this siege and running up these tremendous debts? What is your answer to that?

Mr. PICKENS. Well, Mr. Chairman, I think what you are hearing as far as shutting down the Gulf research center in Pittsburgh and cutting back on research in Bartlesville for Phillips does not relate to the search for oil and gas. I think those are other projects that they were working on, especially at Phillips.

Now, we had nothing to do, nor the debt that Phillips took on has nothing to do, with their cutting back on their research, from what I am told inside the Phillips organization. So that is out of proportion.

As far as closing down the R&D on Gulf, it is because Chevron felt they had a duplication going on there. I think they absorbed some of the R&D people. And Dr. Winerty, that was vice president for R&D for Gulf, has gone with the Texas Medical Center in Houston. And Dick Winerty is a good friend of mine.

But I don't think you are going to have any loss of R&D there in the combination of Chevron and Gulf. I think there was some duplication going on.

As far as what happens to Unocal, we have made it very clear that in our plan, in taking over Unocal, that we see no reason to reduce any divisions of the company or numbers of personnel.

Senator CHAFEE. All right, thank you, gentlemen. I appreciate your coming.

Mr. PICKENS. Thank you.

Mr. JACOBS. Thank you.

Senator CHAFEE. The next panel is Mr. Creson, president and chief executive officer of Crown Zellerbach; Mr. O'Toole; Mr. Bretherick; and Mr. Norris.

Gentlemen, if you would line up in that order that would be helpful; facing us, Mr. Creson, and then next from left to right as you face us, Mr. O'toole, Mr. Bretherick, and Mr. Norris, whom we know from past visits here.

Now gentlemen, if the others were raiders, I think this panel represents targets or those who have been targets, or those who are concerned about targets.

Why don't you proceed, Mr. Creson.

STATEMENT OF WILLIAM T. CRESON, CHAIRMAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, CROWN ZELLERBACH CORP., SAN FRANCISCO, CA

Mr. CRESON. Thank you, Senator.

would like to start with a request for inclusion of the prepared tement which we have submitted for the record. And having e that, I will identify myself as chairman of the board and chief cutive officer and president of Crown Zellerbach.

rown Zellerbach is a $3 billion industrial corporation. We have 00 shareholders, 19,000 employees, facilities in excess of 50 in- strial plants in 35 States throughout the country, with constitu- s in States of at least 15 members of the Finance Committee d 100 percent of those present here right now. [Laughter.]

rown Zellerbach is an interesting company. It is a company t is in the process of a turnaround, perhaps something more n halfway through it.

would put that in the context of Senator Bentsen's observations lier. About 3 years ago our independent directors did step up to iduciary responsibility on behalf of their shareholders, and they indeed disentrench an established management and turned the npany over to me as the chief executive officer, at which point have been able to begin producing and conducting I think a aningful turnaround in the economic affairs of our stake holders d an increasingly developing value for our shareholders.

think the most significant testimony on behalf of the progress that turnaround is that a couple of weeks ago Sir James Gold- ith launched a hostile tender attempt at taking over our compa- , just as he has done with a series of forest products companies the last 2½ years. We are not the first; we are the fourth target Sir James Goldsmith.

Some 2 years ago he acquired control and proceeded with the ssic junk bond leveraged finance of bust-up acquisition of Dia- ond International Corp. He paid about $42 a share to acquire the npany, liquidated the plants and facilities, got his $42 back, and ded up owning, in effect for free on his account, about 1,700,000 res of timberland, which various analysts and publicists have lued at something approaching $500 million. That is $500 million value that the shareholders of Diamond International did not re- ze in that transaction.

He proceeded a bit more than a year ago in a classic approach, to Regis, that ended up in a greenmail takeout for him, and subse- ently exposed St. Regis to successive greenmail efforts which fi- lly ended up in St. Regis becoming a part of Champion Interna- nal.

He turned his interest last summer toward the Continental oup and was a catalyst in the Continental Group disappearing m the American scene.

He has now approached us. Why?

would submit to you, despite some of the comments you heard m the SEC representative, that the stock market may indeed be good mechanism for determining price, but it is not a very effec- e mechanism for determining values in our present situation d in our present economy. The stock market clearly prices equi- s in the short term on a multiple of earnings, but it is less effec- e in determining asset values—it may establish a basis as a used chinery market, but by no means does it provide a proper valu- on of long term tangible natural resource assets. And it is more an a coincidence that the companies being subjected to these leveraged junk-bond financed takeouts today have significant values in natural resources, whether it is timber as a renewable resource, or oil and gas, or extractive minerals—copper or whatever.

We as a company are not opposed to all hostile takeovers. What we do think is bad is the combination of takeovers that bring together extreme leverage, very risky securities, the potential liquidation of jobs that serve the national interest, the personal enrichment of one particular clever financial speculator, at the potential cost of significant harm to creditors, employers, and hundreds of communities.

We support S. 632 as well as the Boren-Nickles bills. We think that junk bond interest should no longer be permitted for a deduction, and that the tax in the step-up basis should be established.

I would close with a comment that, besides hearing remarks about entrenchment—well, I would conclude at that point.

Senator CHAFEE. Go ahead.

Mr. CRESON. Well, there has been an observation made about inept management, and I want to concede to ineptness. I am not inept in organizing and running a company in a simple way—it's organized simply, it's public, it's visible, people know what we do, and we pay our taxes. I am inept at organizing structures such as James Goldsmith has, which are based on a Lichtenstein Foundation which controls interlocking holding companies in exotic places like the Cayman Islands, the Bahamas, the Netherlands Antilles, Panama, and Hong Kong. If I am guilty of ineptness in that regard, I accept it.

Thank you.

Senator CHAFEE. All right, thank you.

We will skip now to Mr. Norris, who has an appointment.

Go ahead, Mr. Norris. Why don't you proceed.

[Mr. Creson's written testimony follows:]

STATEMENT OF

WILLIAM T. CRESON

CHAIRMAN, CHIEF EXECUTIVE OFFICER AND PRESIDENT

CROWN ZELLERBACH CORPORATION

BEFORE THE

COMMITTEE ON FINANCE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

UNITED STATES SENATE

APRIL 22, 1985

Mr. Chairman and members of the committee:

My name is William Creson. I am chairman, chief executive officer and president of Crown Zellerbach Corporation. I express my appreciation to this committee for your attention to the very constructive legislation embodied in S.632, S.420 and S.476 and my commendation to Senator Chafee, Senator Boren and Senator Nickles for introducing these bills.

Our company is well known to many of you. It is the seventh largest paper and forest products company, with sales of over $3 billion. At the end of 1984 we had more than 23,000 shareholders, and 19,000 employees at some fifty manufacturing or related facilities and some seventy distribution locations in thirty-five states. Fifteen members of this committee have Crown Zellerbach facilities in their states. Our major products are paper, timber and wood products, packaging, plastic films, corrugated containers and non-woven fabrics, and we manage some two million acres of prime timberlands in Oregon, Washington, Louisiana, and Mississippi where our largest operations are located.

Over the past three years, Crown Zellerbach has been in the midst of one of the major corporate turn-arounds in the paper and forest products industry. We have reinforced our technical and other strengths with the largest capital investment program in our history, with innovative thrusts into very promising new product areas, and with intensively focused management effort, all directed toward our number one objective: a steady increase in long-term value for our shareholders. In spite of problems in the general conomy and severe dislocations in our industry, we have had some major successes and ave moved up sharply in competitive performance relative to peer competitors since 982. A major turnaround of a large corporation takes time, but I believe that the orward momentum that we have already generated is a model of commitment to building hareholder value, to the pride and productivity of a splendid work force, and to the well eing of the many small communities that are the heart of Crown Zellerbach.

Two weeks ago we became the subject of a tender offer for control of our company by the Anglo-French financial speculator, Sir James Goldsmith. It is perfectly true that some speculators, arbitrageurs, and other shareholders sometimes make short-term stock market profits out of such a takeover raid. But the kind of devastating interruption of the momentum of this company that is threatened by this tender offer will only mean that the long run fair value of Crown Zellerbach will never accrue to the present stockholders of Crown Zellerbach. If it would, why would a raider want the company? Those benefits would accrue to the raider. He wants to get those values for himself, personally, and in the not too distant future by seizing control of Crown at a bargain price today. That is precisely what this debate is all about. Everything else is talk.

Crown is the latest company to be targeted in the paper and forest products industry. St. Regis Paper, the Continental Group and Diamond International were all subjects of hostile takeover attempts within the past year or two. St. Regis, after two greenmailing moves -- one involving Mr. Goldsmith -- was taken over by Champion International, acting as white knight. The Continental Group was pushed by Mr. Goldsmith into the hands of a white knight, which began liquidating the assets. Diamond International fell to Mr. Goldsmith. Earlier, Evans Products was taken over by another well known raider. Its stock fell from 24 to 2 and it is in bankruptcy. Southwest Forest Products was threatened also, and another foreign investor recently took a 25% position in Scott Paper and may increase his position when a standstill agreement expires at the end of this year.

The Goldsmith tender is already having a financial effect on Crown Zellerbach. A week ago Friday, only two days after the tender offer was announced, Standard and Poor's placed Crown on its credit-watch surveillance list. Part of Mr. Goldsmith's proposal is to purchase 51 percent of Crown, which Standard and Poor's stated "would result in a high level of financial risk at the surviving entity that would sharply diminish levels of credit protection for Crown's credit holders." This is hardly a surprise. Only one day after approval of the acquisition of Diamond International by Sir James Goldsmith two and a half years ago, both Standard and Poor's and Moody's dropped Diamond debt ratings from double A to double B-minus, meaning from "very strong" to "predominantly speculative" in terms of ability to pay interest and principal.

I am sure that what happens in a target company, if it is taken over, is not difficult for this committee to picture. The financial restructuring caused by the raid creates no new assets, resources or wealth. It merely shifts ownership and replaces equity with enormous junk bond debt at extremely high junk bond rates--as high as 20 percent--as the corporation's financial structure is undermined. Therefore, earnings are absorbed in servicing the junk bond debt that the raider floated to finance the raid. In consequence, the company is suddenly saddled with the problems classically associated with lack of capital: management flexibility and risk-taking are gone, no funds are available for plant and equipment investment, for expansion, or for research and product development, growth is precluded, the company's relative competitive ability declines, its productivity declines, morale declines, talented people leave, comparable talent cannot be recruited and loyal employees lose their jobs.

The effects are the exact opposite of the government's goal of reindustrializing America and increasing our national productivity. Generalized testimony submitted to Congress in the past three weeks about letting the "free market work" in the form of takeover raids in order to accomplish that objective is just not relevant. What really happens is that reindustrialization is one of the losers in the total takeover process, along with the target company's creditors, employees, minority shareholders and the federal government.

But this is only the beginning. The Diamond International history brings the scenario full turn. As reported in Fortune Magazine of October 17, 1983, in the ten months following the acquisition what the raider "managed" was "one of the largest liquidations of a U.S. company....He and a skeleton staff of three executives in New York have sold six divisions and negotiated tentative deals for three others." All that is left of Diamond is 1,700,000 acres of trees, and Fortune put Mr. Goldsmith's profit at more than $500 million. It is important to emphasize that no minority shareholders shared the gain with Mr. Goldsmith, because there were no minority shareholders. Through successive purchases he had acquired the entire ownership at prices he was willing to offer for Diamond stock so that all the basic long-term values that he turned to cash through his liquidations accrued solely to him directly or through the enterprises he controlled.

If a takeover raider is able to gain control of Crown Zellerbach at a large discount from the real value of the company to its stockholders, he could liquidate it exactly as was done with Diamond International. The process is simple to understand: spin off business units and split off plants that are now closely inter-related, sell them piece by piece for a total price that would be well above the raider's total cost, pay off the junk bond debt. The cash balance plus any remaining assets, or proceeds from their sale, would represent the raider's profit on the entire transaction, right down to total liquidation if he chose. And, assuming he bought out all remaining minority stockholders after once gaining a controlling position, which is a high probability, all of this profit would go to him exactly as in the Diamond acquisition.

It is essentially because of the opportunity to exploit undervalued assets in this way that takeover raiding has so greatly intensified and accelerated. The stock market may be fairly efficient in valuing current earnings if one accepts the assumptions about appropriate price-earnings ratios that are in vogue at any given time. It can be reasonably accurate in assigning liquidating values to used machinery. But the stock market is not effective in valuing the future worth of latent assets, particularly natural resources, be they oil and gas, coal, copper, other extractive minerals, or our most important renewable resource, trees. These resources must be viewed in a long-term perspective, reflecting such considerations as the long growth cycle of a forest and the fact that prices for such basic world-wide commodities tend to move in very long-term cycles. Today's stock market, however, does not take a long-term perspective. It is dominated and priced by institutions whose money managers increasingly price it---that is, value it---on an extremely short-term basis. Consequently, the value assigned by the stock market to the assets of a natural resource company is set by short-term managers of other people's money, not by the managers of the resource business itself. This is why few companies with a major stake in natural resources, the true shareholder value of which depends on longer term considerations, are being priced by the market at a value properly assignable to them as a business operation.

Crown Zellerbach is a classic example. Several years ago one of the leading Wall Street analysts valued us at $115 on timber holdings alone, when we were selling at roughly 40 on the New York Stock Exchange. Only some eight months ago, when our stock was about at 30, another recognized analyst valued us at 60. In addition, we have natural gas reserves in Louisiana that cannot yet be fully evaluated because of their depth, and we are constantly granting leases to oil and gas companies who approach us for drilling rights both in the south and the Pacific Northwest. There is no way of meaningfully estimating the value of hydrocarbons that may be discovered on these properties.

But Mr. Goldsmith did not build his international empire based on happenstance. He knows that there is potential for substantial oil and gas values on our properties, that our timber is carried on our books at extremely low historic cost, that a recurrence of inflation would almost certainly re-value these resources upward, and that a fine, efficient, low-cost on-going paper plant can be acquired through a takeover for a fraction of the cost of building a comparable greenfield mill. He knows, in addition, that he is moving on our company after three years of a difficult and painful, but enormously valuable, restructuring program, and just after very large investments have been made in order to reduce costs at major facilities, investments that will be highly rewarding over the longer term.

Moreover, this is truly a national issue, cutting across various industries. It is also international because of the effects of junk bond financing of takeovers on the capital structure of the seized companies, and therefore on their productivity and the productivity and international competitive effectiveness of the American economy.

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Professor Thurow of M.I.T. has made the following observations that are relevant to this point. The English speaking nations - the United States, Canada, Great Britain, Australia, and New Zealand - were the five worst among the 20 worst performing significant economies over the past 20 years, and in the five years from 1978 through 1982 the United States lagged behind all its major competitors - France, Japan, Italy and Germany - in productivity gains. They ranged from gains of 2.1% to 3.6%. Ours was .5%. He adds that our reinvestment in plant and equipment is running at half the rate of that of Japan and only two-thirds that of Europe.

Our laws should not encourage junk bond financing that promotes hostile corporate takeovers and liquidations that can further these effects. The implications for our economy in terms of research and development, reinvestment in plant and equipment, and the other great forces for improved productivity and reindustrialization are profound, and it is the large American corporations, built over many decades into the principal wealth creating forces of the American economy, that provide the greatest of these forces and thus function as the offset to the central economic planning agencies of our major competitor nations. The role of these corporations in the international competitive effectiveness of our economy should not be fragmented or otherwise weakened, but should be strengthened.

For all these, and many other, reasons we strongly support the thrust of S.632, S.420 and S.476 that will deter inefficient and non-consensual changes in corporate control. In our view, those provisions of the Internal Revenue Code that subsidize raiders by permitting deductions for interest on hostile takeover "debt" and that permit the untaxed increase in the basis of corporate assets in the hostile takeover context, should be amended along the lines embodied in these bills.

The emerging form of hostile takeover financed through the issuance of subordinated ndebtedness is of particular concern. Enormous amounts of this so-called junk bond debt are sold to finance takeover raids, solely on the premise that the target company's assets would be liquidated to the extent required to pay off these debentures. The investment banking commission on junk bond underwritings--reportedly three to seven times higher than on investment grade bonds--creates an extreme marketing incentive. But the investment bankers who market junk bonds have no obligation to our shareholders, nor to the communities where we operate. The financing done, they leave the raider to deal with these constituencies. Professor Edward Altman of the New York University Graduate School of Business estimates that low-rated, public non-convertible debt quadrupled in six years from about $10 billion in 1978 to about $42 billion in 1984, when he estimates that it represented more than 11% of the total corporate debt market versus less than 4% in 1978. By raising the debt-equity ratio to totally unsound financial levels, the pernicious practice of loading this high risk debt into the capital structure of the surviving enterprise effectively shifts the downside risks of the target's business from the traditional common equity shareholders to the subordinated debt holders.

Accordingly, in our view, the proposed legislation would treat "junk bonds" issued in hostile takeovers in a manner consistent with their economic status as risk capital.

We also endorse those proposals that would make the present election under Section 338 of the Internal Revenue Code mandatory in the case of stock purchases pursuant to a hostile takeover and would make Section 337 unavailable in such circumstances. These amendments would insure that any step-up in the basis of the target company's assets would give rise to taxable gain and would insure that the tax attributes of the target corporation would be extinguished. Going one step further, we would also recommend that no increase in the basis of a target's assets be permitted for the amount of tax paid on the step-up.

With the foregoing changes a degree of neutrality will be restored to the tax law which is presently threatened with massive subversion from hostile takeovers.

We urge these tax law changes, fully realizing the legislative difficulties, because we doubt that Williams Act recourse can stop this unhealthy epidemic of hostile takeovers and something must be done. Clearly, such activity should not be aided and abetted by the unintended benefits of existing tax law.

Without desiring to divert the committee's attention from the critical legislative proposals before it, we confess that we do not know whether enactment of this legislation would inhibit Mr. Goldsmith and his complex web of tax-haven based, off-shore entities since we are not sure whether he and they pay or will pay United States income taxes. The principal companies reported to be holding shares in Crown Zellerbach are a Cayman Islands company and a Netherlands Antilles company. A majority of the Cayman Islands company is owned by a Panamanian corporation. A Lichtenstein foundation and Mr. Goldsmith own the stock of the Panamanian company. The Netherlands Antilles company is in turn owned by a Hong Kong corporation. One can only wonder with such a corporate structure how much of the gains generated by an ultimate liquidation process will escape taxation.

This concludes my prepared statement. I would like to thank the committee again for the opportunity to appear and I urge your earliest legislative action on this subject.

STATEMENT OF WILLIAM C. NORRIS, CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER, CONTROL DATA CORP., MINNEAPOLIS, MN

Mr. NORRIS. Thank you, Mr. Chairman, for the opportunity to be here today.

First I want to acknowledge a debt. Just over 2 years ago I appeared before another subcommittee chaired by you, Mr. Chairman, in support of legislation that would clarify the application of our antitrust laws to joint research ventures. That hearing was the very first held on the subject. Ultimately, the National Cooperative Research Act of 1984 was enacted, and I want to express my gratitude to you, Mr. Chairman, and to the other members of the subcommittee.

Senator CHAFEE. Well, things do happen once in a while.

Mr. NORRIS. You will recall that that legislation is designed to encourage companies to work together to improve our country's competitiveness in world markets. American industry has begun to respond. But critical to such cooperation is an environment of trust and mutual respect among firms. Hostile takeovers destroy trust and thus are the very antithesis of cooperation.

In the short time available I will focus mainly on that major concern. Other concerns will only briefly be mentioned; they are fully described in the written submission.

It would be difficult to overstate the potential of cooperation on the one hand and, on the other, the seriousness of the foreign competitive threat.

A good perspective of the foreign competitive challenge which cuts across the breadth of American industry is in the report recently issued by the President's Commission on Industrial Competitiveness. In industry after industry the United States is losing market share. Even in high technology industries, the United States has lost market share in 7 out of 10 sectors. Electronics posted an overall trade deficit in 1984, and our bilateral trade deficit with Japan is likely to surpass our deficit in automobiles.

Obviously, we must increase efforts to develop new, better, lower-cost products. And this means either more funding for research and development or to get more results from what is presently being spent.

Every company I know about is spending as much as can be afforded. The only practical answer is to vastly increase cooperation in research and development to increase efficiency. We know cooperation works. For example, in the MCC Research Consortium, Control Data is getting a 9-to-1 gain in dollars invested versus results.

Therefore, it is urgent that cooperation be vastly increased. A major step in achieving that goal is to remove the causes of the hostile takeover frenzy.

Among our other concerns is the misuse of capital. Takeover attempts and defenses not only soak up a limited resource—capital—but, of greater importance, the massive debt indigenous to such transactions can cripple the ability of companies to grow and compete in the future, or in extreme cases to even survive.

Another concern: As companies strive to avoid becoming targets, the inordinate management attention that is riveted to short-term results.

A third concern is that, in hostile takeovers, relationships with suppliers, customers, employees, and communities are severely disrupted. All too often the debate over hostile takeovers has focused on the rights of shareholders. We must not lose sight of the fact that increasingly society at large has a stake.

Finally, the entrenched management fallacy. Advocates for hostile takeovers contend that hostile takeovers protect shareholders from incompetent management, but just the opposite is true. The current ease with which takeovers occur in fact pressures management to behave incompetently.

There are a number of remedies recommended in my written submission. Suffice it to say for the moment, Control Data strongly endorses the comprehensive approach represented by your bill, S. 631. Your bill does not prohibit hostile takeovers; it encourages rational economic action and effectively would preclude the coercive and destructive tactics that characterize today's environment.

Control Data also favors legislation which would end the senseless governmental subsidization of hostile takeovers currently embodied within our tax laws. These provisions reward bidders by permitting the interest on debt borrowed to finance hostile takeovers to be deducted, and by allowing required assets to be depreciated from a higher base.

Thus, in principle we also strongly support the intent embodied in your other proposal S. 632, as well as in bills introduced by Senators Boren and Nickles.

In concluding, let me note that hostile takeovers are not part of some long revered, proud American tradition to be preserved and nurtured at any cost. In fact, they were unheard of before the mid-sixties.

Today's hostile takeover environment exaggerates an already-too-great focus on short-term performance. It rewards the simple rearranging of assets. And above all, it shifts attention from the development and production of products, the creation and retention of jobs, and the increasing challenge from international competitors.

To help meet the serious competitive threat, companies must be encouraged to cooperate. Yet, as I said, hostile takeovers are the very antithesis of cooperation. And the quickest way to accomplish more cooperation is for Congress to act now to remove the causes of the hostile takeover frenzy.

Thank you.

Senator CHAFEE. Thank you, Mr. Norris.

Mr. O'Toole, we've heard a lot about Phillips, and here you are.

[Mr. Norris' written testimony follows:]

STATEMENT OF

WILLIAM C. NORRIS

CHAIRMAN OF THE BOARD AND CHIEF EXECUTIVE OFFICER

CONTROL DATA CORPORATION

BEFORE THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

APRIL 22, 1985

MR. CHAIRMAN AND MEMBERS OF THE SUBCOMMITTEE:

1. INTRODUCTION.

MY NAME IS WILLIAM C. NORRIS, CHIEF EXECUTIVE OFFICER OF CONTROL DATA CORPORATION, WHICH IS HEADQUARTERED IN MINNEAPOLIS, MINNESOTA.

I WANT TO THANK YOU, MR. CHAIRMAN, FOR THE OPPORTUNITY TO BE HERE TODAY, AND TO COMMEND YOU FOR YOUR LEADERSHIP IN CONVENING THIS INVESTIGATION INTO THE EXTENT TO WHICH TAX AND OTHER LAWS HAVE INFLUENCED (IF NOT ENCOURAGED) THE RECENT WAVE OF HOSTILE TAKEOVERS THAT HAS COME TO DOMINATE THE BUSINESS PAGES OF OUR NATION'S NEWSPAPERS.

BEFORE TURNING TO THAT SUBJECT, HOWEVER, I WOULD BE REMISS IF I DID NOT TAKE A MOMENT AT THE OUTSET TO ACKNOWLEDGE A DEBT. IT WAS JUST OVER TWO YEARS AGO THAT I APPEARED BEFORE ANOTHER SUBCOMMITTEE CHAIRED BY YOU, MR. CHAIRMAN, IN SUPPORT OF LEGISLATION THAT WOULD CLARIFY THE APPLICATION OF OUR ANTITRUST LAWS TO RESEARCH JOINT VENTURES. THAT HEARING WAS THE VERY FIRST HELD ON THAT SUBJECT; ULTIMATELY, THE NATIONAL COOPERATIVE RESEARCH ACT

OF 1984 WAS ENACTED, AND I WANT TO EXPRESS MY GRATITUDE TO YOU, MR. CHAIRMAN, AND THE OTHER MEMBERS OF THE SUBCOMMITTEE.

YOU WILL RECALL THAT LEGISLATION IS DESIGNED TO ENCOURAGE COMPANIES TO WORK TOGETHER TO IMPROVE OUR COUNTRY'S COMPETITIVENESS IN WORLD MARKETS. AMERICAN INDUSTRY HAS BEGUN TO RESPOND. BUT CRITICAL TO SUCH COOPERATION IS AN ENVIRONMENT OF TRUST AND MUTUAL RESPECT AMONG FIRMS. HOSTILE TAKEOVERS DESTROY TRUST AND ARE THUS THE ANTITHESIS OF COOPERATION.

IT WOULD BE DIFFICULT TO OVERSTATE THE POTENTIAL OF COOPERATION ON THE ONE HAND AND ON THE OTHER THE SERIOUSNESS OF THE FOREIGN COMPETITIVE THREAT.

A GOOD PERSPECTIVE OF THE FOREIGN COMPETITIVE CHALLENGE WHICH CUTS ACROSS THE BREADTH OF AMERICAN INDUSTRY IS IN THE REPORT RECENTLY ISSUED BY THE PRESIDENT'S COMMISSION ON INDUSTRIAL COMPETITIVENESS. IN INDUSTRY AFTER INDUSTRY, THE U.S. IS LOSING WORLD MARKET SHARE. EVEN IN HIGH TECHNOLOGY INDUSTRIES, THE U.S. HAS LOST MARKET SHARE IN SEVEN OUT OF TEN SECTORS. ELECTRONICS POSTED AN OVERALL TRADE DEFICIT IN 1984, AND OUR BILATERAL TRADE DEFICIT IN ELECTRONICS WITH JAPAN IS LIKELY TO SURPASS OUR DEFICIT IN AUTOMOBILES.

OBVIOUSLY WE MUST INCREASE EFFORTS TO DEVELOP NEW, BETTER, LOWER COST PRODUCTS. THIS MEANS EITHER MORE FUNDING FOR RESEARCH AND DEVELOPMENT OR TO GET MORE RESULTS FROM WHAT IS PRESENTLY BEING SPENT.

EVERY COMPANY I KNOW ABOUT IS SPENDING AS MUCH AS CAN BE AFFORDED. THE ONLY PRACTICAL ANSWER IS TO VASTLY INCREASE COOPERATION IN RESEARCH AND DEVELOPMENT TO INCREASE EFFICIENCY. WE KNOW COOPERATION WORKS. FOR EXAMPLE IN THE MCC RESEARCH CONSORTIUM, CONTROL DATA IS GETTING A NINE-TO-ONE GAIN IN DOLLARS INVESTED VERSUS RESULTS ATTAINED.

FURTHER EVIDENCE THAT COOPERATION WORKS IS FURNISHED BY JAPAN, E.G., DURING THE YEARS OF 1981 AND 1982, COOPERATION WITHIN INDUSTRY INCREASED 40 PERCENT.

THEREFORE IT IS URGENT THAT COOPERATION BE VASTLY INCREASED AND A MAJOR STEP IN ACHIEVING THAT GOAL IS TO REMOVE THE CAUSES OF THE HOSTILE TAKEOVER FRENZY.

THAT IS WHY I AM HERE AGAIN TODAY. CONTROL DATA IS NOT A TARGET UNDER SIEGE -- ALTHOUGH IN TODAY'S ENVIRONMENT, EVERY PUBLIC COMPANY, REGARDLESS OF INDUSTRY OR SIZE, IS POTENTIALLY AT RISK. BUT FOR ALMOST TWO DECADES I HAVE BEEN PUBLICLY VOICING MY ALARM ABOUT THE PROFOUNDLY

NEGATIVE IMPACTS OF HOSTILE TAKEOVERS ON THE ECONOMIC AND SOCIETAL HEALTH OF THE UNITED STATES. I INTEND TO CONTINUE TO DO SO; AND I AM ENCOURAGED THAT OTHERS HAVE BEGUN TO SHARE THIS ALARM -- AS EVIDENCED BY THIS AND SEVERAL OTHER RECENTLY HELD OR SCHEDULED CONGRESSIONAL HEARINGS.

2. THE ROLE AND IMPACT OF TAKEOVERS.

AS THIS COMMITTEE KNOWS, U.S. TAX LAWS HAVE HISTORICALLY SOUGHT TO SERVE MANY ENDS IN ADDITION TO RAISING REVENUE. IRRESPECTIVE OF PHILOSOPHICAL DEBATES ABOUT THE GENERAL WISDOM OF THIS, OUR COUNTRY HAS ALWAYS USED (AND PROBABLY ALWAYS WILL USE) ITS TAX POLICIES TO ENCOURAGE ACTIVITY BELIEVED DESIRABLE AND TO DISCOURAGE ACTIVITIES THOUGHT UNDESIRABLE -- WHETHER OVER THE NEAR OR LONG TERM. THUS, AS WITH ANY OTHER ISSUE, THE INITIAL QUESTION IS WHETHER HOSTILE TAKEOVERS CONSTITUTE THE SORT OF ACTIVITY TO BE ENCOURAGED OR DISCOURAGED, OR WHETHER TAX LAWS SHOULD BE SIMPLY STRUCTURED SO AS TO BE "NEUTRAL."

PARTIES WHO ARE INTERESTED IN OR HAVE STUDIED THE TAKEOVER PHENOMENA FALL, NOT SURPRISINGLY, INTO TWO DISTINCT CAMPS. CONTROL DATA IS DECIDEDLY IN THE CAMP BELIEVING THAT THE ACTUAL OR POTENTIAL HARM CAUSED BY [illegible] TAKEOVERS -- OR BY AN ENVIRONMENT THAT ENCOURAGES HOSTILE

TAKEOVERS -- FAR OUTWEIGHS ANY ACTUAL OR THEORETICAL BENEFITS, MOST OF WHICH CAN BE AND ARE ACHIEVED THROUGH OTHER MECHANISMS. AMONG OUR MAJOR CONCERNS:

A. MISUSE OF CAPITAL.

TAKEOVER ATTEMPTS AND DEFENSES NOT ONLY SOAK UP A LIMITED RESOURCE -- CAPITAL -- BUT, OF PERHAPS GREATER IMPORTANCE, THE MASSIVE DEBT INDIGENOUS TO SUCH TRANSACTIONS CAN CRIPPLE THE ABILITY OF COMPANIES TO GROW, PROSPER AND COMPETE IN THE FUTURE OR, IN EXTREME CASES, TO EVEN SURVIVE. AS SECURITIES AND EXCHANGE COMMISSION CHAIRMAN, JOHN SHAD, HAS POINTED OUT:

> "CORPORATE TAKEOVERS AND BUYOUTS ARE FINANCED THROUGH LARGE LOANS. THE NET EFFECT IS THAT DEBT IS BEING USED TO RETIRE EQUITY, WHICH IS KNOWN AS LEVERAGING UP A COMPANY'S CAPITALIZATION. THE GREATER THE LEVERAGE, THE GREATER THE RISKS TO THE COMPANY, ITS SHAREHOLDERS, CREDITORS, OFFICERS, EMPLOYEES, SUPPLIERS, CUSTOMERS, AND OTHERS ... THE MORE LEVERAGED TAKEOVERS AND BUYOUTS TODAY, THE MORE BANKRUPTCIES TOMORROW ... THE LEVERAGING UP OF

AMERICAN ENTERPRISE WILL MAGNIFY THE ADVERSE CONSEQUENCES OF THE NEXT RECESSION OR SIGNIFICANT RISE IN INTEREST RATES."

NOR IS THIS CONCERN JUST THEORETICAL. RECENT EXAMPLES OF TARGETS WHO MUST NOW SERVICE MOUNTAINS OF DEBT INCLUDE PHILLIPS PETROLEUM, CONTINENTAL GROUP, AND TWENTIETH CENTURY FOX FILM CORP. AND WHILE A FEW SHAREHOLDERS MAY HAVE PROFITED HANDSOMELY, THE ABILITY OF THESE AND OTHER FIRMS SIMILARLY SITUATED TO SURVIVE THE NEXT ECONOMIC DOWNTURN -- AND ALL THAT PORTENDS FOR THEIR EMPLOYEES AND OTHER CONSTITUENCIES -- HAS BEEN UNQUESTIONABLY JEOPARDIZED.

I MIGHT ADD, MR. CHAIRMAN, THAT THE CURRENT CRISIS IN THE ENTIRE AMERICAN FARM ECONOMY IS PERHAPS THE MOST ELOQUENT TESTIMONY THERE IS AS TO THE ECONOMIC AND HUMAN TRAGEDY THAT CAN RESULT FROM EXCESSIVE LEVERAGING. WE HARDLY NEED A REPEAT IN OTHER SECTORS.

B. STRATEGIC DISTORTION.

AS COMPANIES STRIVE TO AVOID BECOMING TARGETS -- TO PUSH SHARE PRICES CONTINUOUSLY UPWARD -- MANAGEMENT ATTENTION IS RIVETED TO SHORT-TERM RESULTS. AS PETER DRUCKER HAS SAID:

> "A GOOD MANY EXPERIENCED BUSINESS LEADERS I KNOW NOW HOLD TAKEOVER FEAR TO BE A MAIN CAUSE OF THE DECLINE IN AMERICA'S COMPETITIVE STRENGTH IN THE WORLD ECONOMY ... IT CONTRIBUTES TO THE OBSESSION WITH THE SHORT-TERM AND THE SLIGHTING OF TOMORROW IN RESEARCH, PRODUCT DEVELOPMENT, AND MARKETING, AND IN QUALITY AND SERVICE -- ALL TO SQUEEZE OUT A FEW MORE DOLLARS IN THE NEXT QUARTER'S "BOTTOM LINE".

THE COROLLARY TO SHORT-TERM FOCUS IS LONG-TERM BLINDNESS. THE CRUCIAL DECISIONS ABOUT WHAT TO KEEP, WHAT TO SELL, WHAT TO SPEND ON -- OR INVEST IN -- BEING MADE TODAY BY THIS COUNTRY'S CORPORATE MANAGERS WILL DEFINE THE LEGACY WE LEAVE TO OUR CHILDREN AND GRANDCHILDREN. BUT INCREASINGLY, AS A RESPONSE TO THE WAY INSTITUTIONAL INVESTORS -- TODAY'S "OWNERS" -- HAVE CHOSEN TO VALUE AMERICAN FIRMS, OUR MANAGERS ARE FORCED TO SELL THE FUTURE SHORT. EVEN OUR SOCIETAL VALUES HAVE BECOME DISTORTED AS PIRATES BECOME FOLK HEROES TO BE ADMIRED AND EMULATED, WITH HEADLINES FOCUSED ON PEOPLE WHO PUT TOGETHER SYNDICATIONS TO REALLOCATE EXISTING WEALTH RATHER THAN THOSE THAT CREATE NEW WEALTH. DISTORTIONS SUCH AS THESE ARE DIFFICULT TO PROVE -- RARE INDEED WOULD BE THE EXECUTIVE WHO WOULD ACKNOWLEDGE A SHORT-TERM

STRATEGY. BUT WE ALL KNOW THE SUBTLE IMPACT OF INCENTIVES AND DISINCENTIVES, AND THEIR EFFECT IS FELT ECONOMY-WIDE; IT IS NOT LIMITED TO PARTICIPANTS IN THE HOSTILE TAKEOVER GAME.

C. TRANSACTIONAL FALLOUT.

IN SPECIFIC TRANSACTIONS, THERE IS FREQUENTLY TRANSACTIONAL FALLOUT, WHERE LONG STANDING RELATIONSHIPS WITH SUPPLIERS, CUSTOMERS, EMPLOYEES AND COMMUNITIES ARE SEVERELY DISRUPTED. IT'S NOT JUST PLANT CLOSINGS AND THE FIRING OF "DUPLICATIVE" MANAGERS -- AS TRAUMATIC AS THAT CAN BE TO THOSE DIRECTLY INVOLVED. THE LOCAL PRESENCE OF AN INDEPENDENT FIRM INVOLVES IRREPLACEABLE INTANGIBLES BEYOND ITS DIRECT PAYROLL. CHARITIES, THE ARTS, EDUCATIONAL, CIVIC AND GOVERNMENTAL ORGANIZATIONS ARE ONLY THE MOST OBVIOUS EXAMPLES OF "QUALITY OF LIFE" INSTITUTIONS THAT RECEIVE ONE LEVEL OF SUPPORT WHEN A FIRM IS DIRECTLY COMMITTED TO A COMMUNITY AND ANOTHER WHEN IT IS NOT.

ALL TOO OFTEN THE DEBATE OVER HOSTILE TAKEOVERS HAS FOCUSED ON THE RIGHTS OF SHAREHOLDERS; WE MUST NOT LOSE SIGHT OF THE FACT THAT, INCREASINGLY, SOCIETY AT LARGE HAS A STAKE.

D. THE "ENTRENCHED MANAGEMENT" FALLACY.

ADVOCATES FOR HOSTILE TAKEOVERS INCLUDE THOSE ACTIVE IN THE GAME, SUCH AS ARBITRAGEURS, AS WELL AS ECONOMISTS OF THE SO-CALLED "CHICAGO SCHOOL." THEY CONTEND THAT HOSTILE TAKEOVERS ARE SIMPLY A PREFERRED FREE-MARKET MECHANISM WHEREBY OUR SOCIETY'S RESOURCES ARE ALLOCATED TO THEIR BEST AND MOST EFFICIENT USE -- IN OTHER WORDS, PREDATION IS NATURE'S WAY. MANY ESPOUSE THIS VIEW AS CONSISTENT WITH AN EMPHASIS ON "DEREGULATION." IT IS NOT, OF COURSE, BUT IT SOUNDS GOOD. TRUE DEREGULATION REQUIRES A CONTEXT WHEREIN PEOPLE ARE IN A POSITION TO MAKE INFORMED, RATIONAL, UNHURRIED AND UNCOERCED CHOICES; A MARKET THAT FLOURISHES ON IGNORANCE, SURPRISE AND "OFFERS THAT CAN'T BE REFUSED" IS FREE ONLY IN A BARBARIC SENSE.

TAKEOVER ADVOCATES ALSO PUT GREAT STOCK IN THE CONTENTION THAT TENDER OFFERS PROTECT THE SHAREHOLDERS OF THE TARGET, AND ARE NEEDED AS A DISCIPLINE ON INCOMPETENT MANAGEMENT. AS POINTED OUT ABOVE, HOWEVER, THE CURRENT EASE WITH WHICH TAKEOVERS OCCUR IN FACT PRESSURES MANAGEMENT TO BEHAVE INCOMPETENTLY.

MOREOVER, SUCH A CONTENTION ASSUMES AT LEAST THREE PREMISES, NONE OF WHICH APPEAR TO BE BORNE OUT BY THE FACTS: (1) THAT MANAGEMENT OF TARGETS ARE INDEED INCOMPETENT; (2) THAT THE PERSONS REPLACING THEM ARE MORE COMPETENT (AND WILL IN FACT OPERATE THE COMPANY); AND (3) THAT THE PERFORMANCE OF COMPANIES HAS BEEN ENHANCED BY THREATENED OR ACTUAL TAKEOVERS. EXPERIENCE HAS SHOWN, HOWEVER: (1) THAT TAKEOVER ATTEMPTS ARE SELDOM MADE ON TARGETS WITH ANYTHING BUT EXTREMELY CAPABLE MANAGEMENT; (2) THAT MANY OF THOSE MOST ACTIVE IN THE TAKEOVER GAME HAVE EITHER NO OR MINIMAL EXPERIENCE IN OPERATING BUSINESSES SIMILAR IN SIZE OR ACTIVITIES TO THE TARGET; AND (3) THAT THE OVERALL PERFORMANCE OF COMPANIES MAY WELL HAVE DECLINED. AS PROFESSOR F. M. SCHERER OF SWARTHMORE COLLEGE RECENTLY POINTED OUT IN TESTIMONY BEFORE ANOTHER CONGRESSIONAL COMMITTEE:

> "IF TAKEOVERS ARE AN IMPORTANT DISCIPLINARY MECHANISM STIMULATING MANAGERIAL EFFICIENCY, ONE MIGHT EXPECT THE RAPID INCREASE IN TAKEOVER ACTIVITY DURING THE LATE 1960S AND LATE 1970S TO HAVE BEEN FOLLOWED BY IMPROVED OVER-ALL ECONOMIC PERFORMANCE -- E.G., ON SUCH DIMENSIONS AS PRODUCTIVITY GROWTH. IN FACT, THE ANNUAL GROWTH OF OUTPUT PER WORK HOUR IN THE ECONOMY'S PRIVATE

NONFARM BUSINESS SECTOR DECLINED FROM 2.6 PERCENT OVER 1947-64 TO 1.7 PERCENT OVER 1964-74 TO 1.4 PERCENT OVER 1974-84."

SINCE TAKEOVERS WERE ESSENTIALLY UNHEARD OF IN THIS COUNTRY PRIOR TO THE MID-1960'S, IS IT IDLE TO SUGGEST THAT THE HOSTILE TAKEOVER ENVIRONMENT HAS IN FACT CAUSED -- OR AT LEAST CONTRIBUTED TO -- THESE DECLINES? JAPANESE MANAGEMENT, FOR EXAMPLE, HAS NOT TO MY KNOWLEDGE BEEN SUBJECTED TO THE ALLEGED "DISCIPLINE" OF THE TAKEOVER ARTISTS, AND YET HAVE BEEN SYSTEMATICALLY SHREDDING ONE U.S. INDUSTRY AFTER ANOTHER.

FINALLY, EVEN IF THERE WERE SOME EVIDENCE THAT HOSTILE TAKEOVERS SERVED TO CHECK THIS BADLY-MANAGED HYPOTHETICAL COMPANY WE KEEP HEARING ABOUT, IT DOESNOT FOLLOW THAT WE SHOULD IGNORE THE COST INVOLVED: NO DOUBT THE JESSE JAMES GANG ALSO KEPT BUSINESS MANAGEMENT ON ITS TOES. IF AND WHEN THE HOSTILE TAKEOVER ARTISTS DO COME UP WITH A LIST -- EVEN A SHORT ONE -- OF "POORLY MANAGED" FIRMS THAT HAVE BEEN TAKEN OVER BY A HOSTILE BIDDER AND SUBSEQUENTLY TURNED AROUND (WHICH I SUGGEST THEY BE CHALLENGED TO DO), WE MUST ALSO ASSURE OURSELVES THAT

THE PRICE OF ANY PARTICULAR ALLEGED TURNAROUND DID NOT EXCEED ITS VALUE. AND EVEN THEN, I SUSPECT THAT FOR EVERY SUCH "RESCUE," AT LEAST FIVE OTHER FIRMS THAT WERE CRIPPLED BY OR FOLLOWING A TAKEOVER COULD BE IDENTIFIED.

THE FUNDAMENTAL POINT, HOWEVER, IS THAT ADVOCATES OF HOSTILE TAKEOVERS ARE RELYING ON ARGUMENTS THAT ARE IRRELEVANT. THEIR ARGUMENTS ALWAYS OPERATE FROM THE UNSTATED ASSUMPTION THAT ANY CHANGES IN THE RULES OF THE TAKEOVER GAME EQUATE TO A TOTAL BARRIER AGAINST FUTURE HOSTILE TAKEOVERS. BUT NO ONE IS ADVOCATING THE ABSOLUTE PROHIBITION OF TAKEOVERS; THAT IS SIMPLY A BOGEYMAN OF THE DEFENDERS OF THE STATUS QUO. THE QUESTION IS WHETHER ENLIGHTENED GOVERNMENT POLICY CAN BE DEVISED THAT WILL ELIMINATE THE DEVASTATING FALLOUT FROM SUCH ACTIVITIES.

3. WHY THE CURRENT "WAVE" OF TAKEOVERS?

LAST YEAR WAS A BANNER YEAR FOR HOSTILE TAKEOVERS. IN THE FIRST NINE MONTHS OF 1984, AS REPORTED BY THE *WALL STREET JOURNAL*, MERGERS, DIVESTITURES AND LEVERAGED BUYOUT TRANSACTIONS TOTALED MORE THAN $103 BILLION, AN INCREASE OF $20 BILLION OVER COMPARABLE TRANSACTIONS FOR ALL OF

1983. 1984 ALSO SAW AN ESTIMATED $80-90 BILLION OF EQUITY SECURITIES REMOVED FROM THE MARKETPLACE BY CORPORATE REPURCHASE, A GOOD PART OF WHICH WAS DRIVEN BY TAKEOVER DEFENSIVE ACTION. THIS ACCELERATING PHENOMENON APPEARS TO RESULT FROM A COMBINATION OF FACTORS.

FIRST, THE STOCK MARKET HAS SUBSTANTIALLY UNDERVALUED MOST COMPANIES IN RECENT YEARS. THE TRUTH OF THE SAYING THAT "EXPLORING FOR OIL ON WALL STREET IS CHEAPER THAN DRILLING FOR NEW RESERVES" IS CERTAINLY NOT LIMITED TO OIL COMPANIES.

SECOND, THE STOCK MARKET HAS BECOME INCREASINGLY DOMINATED BY INSTITUTIONAL INVESTORS, WHOSE FOCUS IS THIS QUARTER'S RESULTS. A PREMIUM -- ANY PREMIUM -- IS READILY GOBBLED UP BY "SHAREHOLDERS" WHOSE MODUS OPERANDI IS TEMPORARILY PARKING FUNDS RATHER THAN INVESTING FOR THE LONG HAUL.

THIRD, THERE SEEMS TO BE AN ENDLESS SUPPLY OF EASY MONEY AVAILABLE FOR HOSTILE BIDS -- WHETHER THROUGH BANK LOANS OR THE LATEST JUNK BONDS, AND WHETHER TO ESTABLISHED FIRMS OR NEOPHYTES. IN ONE RECENT HOSTILE BID FOR A MINNESOTA COMPANY, THE BIDDER HAD A NET WORTH OF $43,000 IN JUNE, RAISED $2 MILLION IN A PUBLIC OFFERING IN JULY, LINED UP A $10 MILLION LINE OF CREDIT IN AUGUST, AND LAUNCHED A TAKEOVER BID IN SEPTEMBER FOR AN ESTABLISHED COMPUTER SERVICES COMPANY WORTH $12 MILLION.

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FOURTH, OUR TAX LAWS SUBSIDIZE HOSTILE BIDS BY PERMITTING THE INTEREST ON DEBT BORROWED TO FINANCE TAKEOVERS TO BE DEDUCTED, AND ALLOWING ACQUIRED ASSETS TO BE DEPRECIATED FROM A HIGHER BASE. EDGAR M. BRONFMAN, THE CHAIRMAN AND CHIEF EXECUTIVE OFFICER OF SEAGRAMS HAS POINTED OUT THE FOLLY IN FORCING THE AVERAGE TAXPAYER TO BE INDIRECTLY FOOTING THE BILL FOR A SIGNIFICANT PART OF CORPORATE TAKEOVER GAMES, A PARTICULARLY PECULIAR AND UNWARRANTED GOVERNMENTAL INTERVENTION IN THE CONTEXT OF THE CURRENT LAISSEZ-FAIRE ECONOMIC TREND.

FINALLY, THE GOVERNMENT REGULATORY FRAMEWORK FOR HOSTILE TAKEOVERS -- THE WILLIAMS ACT -- HAS FAILED TO ACCOMPLISH ITS INITIAL PURPOSE -- THE ASSURANCE OF A "LEVEL PLAYING FIELD" TO TAKEOVER COMBATANTS. THE FACT THAT FOUR OUT OF FIVE COMPANIES "PUT IN PLAY" DO NOT EMERGE UNSCATHED BELIES ANY SUCH CHARACTERIZATION.

GOVERNMENT POLICIES, OR THE LACK THEREOF, CAN HAVE A PROFOUND IMPACT ON EACH ONE OF THESE FACTORS. FOR EXAMPLE, FEDERAL DEFICITS AND THE STRONG DOLLAR CERTAINLY BEAR UPON THE DEFLATED STOCK MARKET VALUE OF AMERICAN FIRMS. BUT I WOULD LIKE TO CONCLUDE MY REMARKS BY FOCUSING ON TWO REFORMS THAT COULD BE MOST DIRECTLY IMPLEMENTED.

4. RECOMMENDED SOLUTIONS.

A. WILLIAMS ACT.

THERE ARE A VARIETY OF WAYS TO CURB SOME OF THE ABUSES AND UNDESIRABLE EFFECTS INHERENT IN TODAY'S HOSTILE TAKEOVER ENVIRONMENT. THOUGH NOT WITHIN THIS COMMITTEE'S JURISDICTION ONE OF THESE IS TO AMEND THE WILLIAMS ACT, THE LAW WHICH NOW INADEQUATELY GOVERNS TENDER OFFERS. THAT APPROACH IS SUGGESTED IN LEGISLATION WHICH HAS BEEN INTRODUCED DURING THIS SESSION BY YOU, MR. CHAIRMAN (S.631), AS WELL AS SENATOR PROXMIRE (S.706), AND, IN THE HOUSE, BY CONGRESSMAN MARKEY (H.R.1480). WHILE THE DETAILS OF THE APPROACHES TAKEN IN THESE PROPOSALS MAY DIFFER, THEY SHARE A COMMON OBJECTIVE: ENSURING INFORMED AND DELIBERATE DECISION-MAKING BY INDIVIDUALS IN A POSITION TO FOCUS ON BOTH THE SHORT AND LONG-RANGE IMPLICATIONS OF ANY PARTICULAR TAKEOVER PROPOSAL. THUS, EACH OF THESE BILLS:

(1) PROVIDES FOR INCREASED DISCLOSURE AS TO THE BIDDER'S GOALS AND BUSINESS PLANS WITH RESPECT TO THE TARGET, AND THE ANTICIPATED EFFECTS OF SUCH ACTIONS ON THE BIDDER AND TARGET, AS WELL

AS UPON THEIR RESPECTIVE SHAREHOLDERS, EMPLOYEES, CREDITORS, SUPPLIERS, CUSTOMERS AND THE COMMUNITIES IN WHICH EITHER OPERATES;

(2) PUTS IN PLACE AN APPROVAL PROCESS WHEREBY OUTSIDE DIRECTORS AND/OR SHAREHOLDERS OF BOTH THE BIDDER AND TARGET COMPANIES WOULD EACH APPROVE ANY PARTICULAR TAKEOVER BEFORE IT COULD BE CONSUMMATED; AND

(3) EXTENDS THE MINIMUM OFFERING PERIOD DURING WHICH A TAKEOVER OFFER MUST REMAIN OPEN, IN ORDER THAT SHAREHOLDERS AND OTHER CONSTITUENCIES HAVE AN ADEQUATE TIME TO WEIGH THE INFORMATION WITH WHICH THEY WILL BE PROVIDED AND TO ENSURE THAT THE MECHANICAL PROCESSES OF APPROVAL CAN BE ACCOMMODATED.

CONTROL DATA STRONGLY ENDORSES THIS SORT OF COMPREHENSIVE APPROACH, AND COMMENDS YOU, MR. CHAIRMAN, FOR TAKING THE LEAD THROUGH YOUR INTRODUCTION OF S.631. YOUR BILL DOES NOT PROHIBIT HOSTILE TAKEOVERS; IT ENCOURAGES RATIONAL ECONOMIC ACTION, AND EFFECTIVELY WOULD PRECLUDE THE COERCIVE AND DESTRUCTIVE TACTICS THAT CHARACTERIZE TODAY'S ENVIRONMENT.

B. INTERNAL REVENUE CODE.

CONTROL DATA ALSO FAVORS LEGISLATION WHICH WOULD END THE SENSELESS GOVERNMENTAL SUBSIDIZATION OF HOSTILE TAKEOVERS CURRENTLY EMBODIED IN OUR TAX LAWS. THESE PROVISIONS REWARD BIDDERS BY PERMITTING THE INTEREST ON DEBT BORROWED TO FINANCE HOSTILE TAKEOVERS TO BE DEDUCTED AND BY ALLOWING ACQUIRED ASSETS TO BE DEPRECIATED FROM A HIGHER BASE. THUS, IN PRINCIPLE, WE ALSO STRONGLY SUPPORT THE INTENT EMBODIED IN YOUR OTHER PROPOSAL, MR. CHAIRMAN (S.632), AS WELL AS IN BILLS INTRODUCED BY SENATORS BOREN AND NICKLES (S.420 AND S.476).

EVEN THOSE OF THE "CHICAGO SCHOOL" SHOULD NOT OBJECT TO MEASURES THAT WOULD PLACE THE GOVERNMENT IN A POSITION OF FINANCIAL "NEUTRALITY" IN THE CONTEXT OF A HOSTILE TAKEOVER BATTLE. UNDER CURRENT LAW, THE GOVERNMENT HAS TAKEN SIDES: IT SUBSIDIZES AND REWARDS HOSTILE BIDDERS, BUT NO COMPARABLE TOOLS ARE AVAILABLE TO TARGETS.

ALTHOUGH CONTROL DATA HAS NO EXPERIENCE WHEN IT COMES TO HOSTILE TAKEOVERS, OUR EXPERIENCE IN OTHER TRANSACTIONS CONFIRMS WHAT CAN ONLY BE CHARACTERIZED AS OBVIOUS IF YOU THINK ABOUT IT: THE TAX

RAMIFICATIONS OF ANY PARTICULAR DEAL PLAY A CRUCIAL ROLE IN DETERMINING ITS STRUCTURE AND TERMS -- AND THUS ITS SUCCESS. IT AMAZES ME THAT ANYONE COULD COTEND OTHERWISE. IF A RAIDER BORROWS $5 BILLION IN JUNK BONDS AT 15%, THE GOVERNMENT IS IN EFFECT ANNUALLY CONTRIBUTING OVER $300 MILLION TO THE TAKEOVER. SUCH A SUBSIDY SHOULD NOT BE ALLOWED TO BE A FACTOR -- PARTICULARLY A DETERMINING FACTOR -- DURING BATTLES AMONG FIRMS AT WAR FOR CORPORATE CONTROL. THIS IS PARTICULARLY TRUE WHERE THE GOVERNMENT'S SUBSIDY IS ALSO ENCOURAGING THE SUBSTITUTION OF DEBT FOR EQUITY -- THE SO-CALLED "LEVERAGING UP" WHICH SEC CHAIRMAN SHAD HAS ALLUDED TO. UNDER SUCH CIRCUMSTANCES, THE ECONOMICS OF EQUITY -- NOT DEBT -- SHOULD APPLY.

SOME HAVE RAISED QUESTIONS CONCERNING (1) THE PRACTICAL APPLICATION OF THE PROCESS WHEREBY A DENIAL OF TAX SUBSIDIES FOR "HOSTILE" TRANSACTIONS WOULD BE TRIGGERED AND (2) THE RATIONALE FOR DISPARATE TAX TREATMENT BETWEEN "HOSTILE" AND "FRIENDLY" TAKEOVERS. LET ME FIRST ADDRESS THE SECOND CONCERN: IN NEGOTIATED TRANSACTIONS, THE TAX CONSEQUENCES ARE ALSO A SUBJECT OF NEGOTIATION; AS PART OF THE "GIVE AND TAKE" IN PUTTING A DEAL TOGETHER, THE PARTIES IN EFFECT SHARE OR MUTUALLY BENEFIT FROM ANY TAX

BENEFITS. IN CONTRAST, IN A HOSTILE TAKEOVER SITUATION, ONE PARTY -- THE RAIDER -- DICTATES THE TERMS OF ANY OFFER AND THEREBY UNILATERALLY USES THE GOVERNMENT'S MONEY AS AN ADDITIONAL WEAPON IN AN ALREADY OVERLOADED ARSENAL.

AS TO THE FIRST CONCERN, MR. CHAIRMAN, UNDER YOUR BILL (S.632) -- AS WELL AS THE OTHERS -- THE INDEPENDENT MEMBERS OF THE TARGET'S BOARD OF DIRECTORS DETERMINE IF AN OFFER IS "HOSTILE". WE AGREE WITH THAT APPROACH, FOR SEVERAL REASONS. FIRST, IT PUTS THE DECISION IN THE HANDS OF PEOPLE WHO ARE IN A POSITION TO OBJECTIVELY EVALUATE A PROPOSAL AS IT AFFECTS ALL OF THE TARGET'S CONSTITUENCIES, BUT WHO THEMSELVES WOULD BE FREE FROM SUGGESTIONS THAT THEY WOULD BE INCLINED TO REJECT AN OFFER IN ORDER TO PROTECT THEIR JOBS. SECOND, THE INDEPENDENT DIRECTORS -- UNLIKE SOME STRANGER OR GOVERNMENT BUREAUCRACY -- ARE BOTH FAMILIAR WITH THE TARGET'S BUSINESS AND THEIR ACTIONS ARE SUBJECT TO A LEGALLY ENFORCEABLE FIDUCIARY DUTY; THEY CAN NEITHER ACCEPT NOR REJECT AN OFFER ARBITRARILY, AND WILL BE DISCIPLINED IF THEY TRY TO. FINALLY, THE PROPOSAL WOULD ENHANCE THE STATURE OF INDEPENDENT DIRECTORS AND WOULD THUS BOTH ENCOURAGE THEM TO SERVE AND PUBLIC COMPANIES TO ELECT THEM -- A DESIRABLE GOAL IN

AND OF ITSELF. THUS, "INSIDERS" WOULD, IN EFFECT, BE FORCED TO ACCEPT OUTSIDE REPRESENTATION, BECAUSE WITHOUT SUCH DIRECTORS, EVEN A CLEARLY HOSTILE OFFER BY DEFINITION COULD NEVER BE DEEMED "HOSTILE" UNDER THE LAW.

FINALLY, A FEW SPECIFIC COMMENTS CONCERNING THE BILLS THAT HAVE BEEN INTRODUCED.

(1) EXCISE TAX ON GREENMAIL PROFITS.

HOWEVER EGREGIOUS THE PAYMENT OF GREENMAIL MAY BE -- AND CONTROL DATA AGREES THAT THE PRACTICE IS CONTEMPTIBLE -- THE FACT IS THAT IN SOME SITUATIONS THE PAYMENT OF "GREENMAIL" MAY BE THE ONLY REMAINING OPTION FOR A TARGET THAT WANTS TO REMAIN INDEPENDENT: WE ARE RELUCTANT, FOR A VARIETY OF REASONS, TO IMPINGE ON THE RIGHT OF A TARGET TO AVAIL ITSELF OF THAT OPTION. FIRST, WE ARE CONVINCED THAT ABUSES IN THE PAYMENT OF GREENMAIL ARE BEING AND WILL CONTINUE TO BE CHECKED THROUGH APPROPRIATE APPLICATION BY STATE COURTS OF THE BUSINESS JUDGMENT RULE. (INDEED, AS REPORTED IN THE WALL STREET JOURNAL ON MARCH 28, 1985, MANY COMPANIES ARE IN THE PROCESS OF ADOPTING ANTI-GREENMAIL CHARTER

AMENDMENTS). SECOND, THE CHIEF BENEFICIARIES OF ANTI-GREENMAIL LEGISLATION ARE THE ARBITRAGEURS, AND WE ARE RELUCTANT TO ENDORSE ANY STEP THAT WILL REDUCE THEIR RISKS AND THEREBY ENCOURAGE THE EXPANSION OF THEIR ACTIVITIES -- IN NUMBERS OR INVOLVEMENT -- IN SECURITIES MARKETS. THIRD, WE SUSPECT THAT IMPOSING AN EXCISE TAX ON GREENMAIL PROFITS MAY HAVE THE PERVERSE EFFECT OF SIMPLY CAUSING THE PRICE OF GREENMAIL TO GO UP, INFLICTING GREATER INJURY ON TARGETS AND SHAREHOLDERS WHO REMAIN -- THAT IS, THE TAX WILL "MERELY BE PASSED ON TO THE CONSUMER." AND FINALLY, AS CAN HAPPEN SO OFTEN WHEN WHAT IS ESSENTIALLY A NON-TAX PROBLEM IS ADDRESSED VIA A TAX REMEDY, THERE IS SUBSTANTIAL RISK THAT -- WHETHER THROUGH INADVERTENCE OR THE FERTILE IMAGINATION OF TAX PRACTITIONERS -- THE REMEDY WILL "MISS" ACTIVITY WHICH SHOULD BE COVERED AND "HIT" ACTIVITY THAT SHOULD NOT.

(2) INTEREST ON HOSTILE ACQUISITION INDEBTEDNESS.

ON THE OTHER HAND, CONTROL DATA STRONGLY SUPPORTS LEGISLATION TO DENY DEDUCTIBILITY OF INTEREST INCURRED IN CONNECTION WITH BORROWING FOR HOSTILE TAKEOVERS. UNLIKE THE PROPOSAL DEALING WITH GREENMAIL, SUCH A PROPOSAL ADDRESSES THE ABUSE OF A SUBSIDY WHICH ALREADY EXISTS IN THE INTERNAL REVENUE CODE.

(3) STEPPED-UP BASIS OF ACQUIRED ASSETS.

WE URGE THAT THE COMMITTEE ALSO PRECLUDE A HOSTILE PURCHASER FROM STEPPING UP THE BASIS OF A TARGET CORPORATION'S ASSETS FOR PURPOSES OF DEPRECIATION AND AMORTIZATION UNLESS THE STEP-UP IS RECAPTURED AND TAXED. PROVISIONS TO THIS EFFECT -- AMENDING SECTIONS 337-338 OF THE IRC -- ARE INCLUDED IN S.632.

THIS IS A PARTICULARLY GRAPHIC EXAMPLE OF A LEGISLATIVE LACK OF "NEUTRALITY" BETWEEN THE BIDDER AND TARGET. IT IS IMPOSSIBLE FOR A TARGET TO *UNILATERALLY* STEP-UP THE BASIS OF ITS ASSETS; A SUCCESSFUL BIDDER, ON THE OTHER HAND, QUALIFIES AUTOMATICALLY, AND USES THE INCREASED CASH FLOW TO FUND ITS ATTACKS.

AS A "TECHNICAL" COMMENT, AND TO PRECLUDE EVASION, THE COMMITTEE MIGHT CONSIDER AMENDING S.632 TO DENY A STEP-UP FOR *ANY* ACQUISITION OF SHARES MADE BY A PARTY SUBSEQUENT TO A HOSTILE OFFER BY SUCH PARTY, RATHER THAN ONLY PURCHASES MADE "PURSUANT TO" A HOSTILE OFFER.

(4) ANOTHER ASPECT OF EXISTING LAW THAT FACILITATES TAKEOVERS.

FINALLY, THE COMMITTEE MIGHT WANT TO EXAMINE IMPOSING TAXES, PERHAPS WAIVABLE UPON THE EXPIRATION OF MINIMUM HOLDING PERIODS, ON PENSION FUNDS OR OTHER LARGE "NON-PROFIT" INSTITUTIONAL INVESTORS -- TO GET AT THE SHORT-TERM INCENTIVES AND FOCUS OF MONEY MANAGERS. AS SUCH HOLDERS HAVE COME TO DOMINATE THE MARKETS, THE SALUTARY EFFECTS OF IMPOSING MINIMAL HOLDING PERIODS FOR CAPITAL GAINS TREATMENT ENVISIONED BY CONGRESS HAVE BEEN USURPED.

IN SUMMARY, AS TO THE ROLE OF OUR NATION'S TAX LAWS ON THE HOSTILE TAKEOVER ENVIRONMENT, CONGRESS NEED NOT EVEN DECIDE WHETHER HOSTILE TAKEOVERS ARE "GOOD" OR "BAD" FOR THE ECONOMY. IT CAN SIMPLY ADOPT A POSTURE OF NEUTRALITY. BUT PRESENT LAW SUBSIDIZES BIDDERS -- AND THAT MUST BE STOPPED. NOR SHOULD WE DELUDE OURSELVES INTO BELIEVING THAT AN END TO TAX SUBSIDIES IS A CURE-ALL. THAT WILL REQUIRE A MORE DIRECT AND COMPREHENSIVE APPROACH -- SUCH AS THAT REFLECTED IN S.631, MR. CHAIRMAN, YOUR PROPOSED AMENDMENTS TO THE WILLIAM'S ACT.

5. CONCLUSION.

PROPONENTS OF THE STATUS QUO AS REGARDS HOSTILE TAKEOVERS ASSUME A MANTLE OF INDIGNATION WHENEVER ANYONE SUGGESTS SOME MODIFICATION TO THE RULES. THEY TALK ABOUT "INCOMPETENT MANAGEMENT" AND THE SANCTITY OF "EFFICIENT CAPITAL MARKET" HYPOTHESES. THEY ALSO OPERATE FROM THE PREMISE -- SINCE IT SUITS THEIR PURPOSE -- THAT ANY PROPOSAL, HOWEVER MODEST, EQUATES TO A "PROHIBITION" OF HOSTILE TAKEOVERS.

MR. CHAIRMAN, HOSTILE TAKEOVERS ARE NOT PART OF SOME LONG-REVERED, PROUD AMERICAN TRADITION TO BE PRESERVED AND NURTURED AT ANY COST. IN FACT, THEY WERE UNHEARD OF BEFORE THE MID-1960's. THEY MAY HAVE A ROLE TO PLAY. BUT THAT ROLE IS BEING ABUSED. THE CONTENTION THAT ANY EXECUTIVE WHO RESISTS A TAKEOVER IS "INCOMPETENT" WHEREAS PEOPLE IN PURSUIT ARE SIMPLY "EFFICIENTLY ALLOCATING RESOURCES" IS A SMOKESCREEN. IN THE REAL WORLD, COMPETENTLY MANAGED COMPANIES ARE THE PRIME TARGETS, AND

THEY ARE THE TARGETS OF INDIVIDUALS MORE OFTEN DRIVEN BY GREED OR EGO THAN ECONOMICS.

FURTHERMORE, PROPOSALS SUCH AS S.631 ARE NOT DRACONIAN, BUT ARE EXCEEDINGLY MODEST ATTEMPTS TO BRING FAIRNESS INTO THE PROCESS. THEY DO NOT PROHIBIT HOSTILE TAKEOVERS. THEY MERELY INJECT SOME SANITY AND FAIRNESS INTO THE PROCESS. WHAT IS SO OBJECTIONABLE TO THE TAKEOVER ARTISTS ABOUT DISCLOSURE? THERE IS NOTHING INCONSISTENT BETWEEN DISCLOSURE AND "FREE" MARKETS. ALTHOUGH THE CORPORATE RAIDERS INVARIABLY ARGUE TO THE CONTRARY, SOCIETY AND CONGRESS HAVE CONSISTENTLY RECOGNIZED THAT DISCLOSURE IS A NECESSARY PREREQUISITE TO THE OPERATION OF ANY FREE MARKET. IN FACT, IT IS A FUNDAMENTAL PRECEPT IN A DEMOCRATIC SOCIETY. I FIND IT IRONIC THAT THESE SELF-PROCLAIMED DEFENDERS OF SHAREHOLDER RIGHTS FEEL THREATENED BY PROPOSALS THAT WOULD SIMPLY PROVIDE SHAREHOLDERS WITH INFORMATION CRITICAL TO A DECISION AND, IN TURN, ALLOW THOSE VERY SHAREHOLDERS THE RIGHT TO VOTE ON A HOSTILE OFFER.

TODAY'S HOSTILE TAKEOVER ENVIRONMENT EXAGGERATES AN ALREADY TOO GREAT FOCUS ON SHORT-TERM PERFORMANCE; IT REWARDS THE SIMPLE REARRANGING OF ASSETS; ABOVE ALL, IT SHIFTS ATTENTION FROM THE DEVELOPMENT AND PRODUCTION OF

PRODUCTS, THE CREATION AND RETENTION OF JOBS, AND THE INCREASING CHALLENGE FROM INTERNATIONAL COMPETITORS -- CONCERNS WHICH SHOULD BE AT THE TOP OF OUR LIST OF NATIONAL PRIORITIES.

TO REITERATE WHAT I SAID EARLIER, U.S. INDUSTRY IS FACING INCREASINGLY SERIOUS PROBLEMS WHICH UNDERMINE ITS INTERNATIONAL COMPETITIVENESS. TO HELP MEET THIS THREAT COMPANIES MUST BE ENCOURAGED TO COOPERATE. A MAJOR ELEMENT IN SUCH COOPERATION IS AN ENVIRONMENT OF TRUST AND MUTUAL RESPECT AMONG FIRMS. HOSTILE TAKEOVERS DESTROY THIS TRUST AND ERODE MUTUAL RESPECT, AND ARE THUS THE VERY ANTITHESIS OF COOPERATION. IT IS URGENT THAT COOPERATION BE VASTLY INCREASED. THE QUICKEST WAY TO ACCOMPLISH THAT IS FOR CONGRESS TO ACT NOW TO REMOVE THE CAUSES OF THE HOSTILE TAKEOVER FRENZY.

THANK YOU. I'D BE HAPPY TO RESPOND TO ANY QUESTIONS OR COMMENTS YOU MIGHT HAVE.

5415J-11

STATEMENT OF J.W. O'TOOLE, VICE PRESIDENT AND GENERAL TAX OFFICER, PHILLIPS PETROLEUM CO., BARTLESVILLE, OK

Mr. O'TOOLE. Thank you, Mr. Chairman.

I am Joseph O'Toole, vice president and general tax officer of Phillips of Bartlesville, OK.

It is a pleasure to appear before this committee as a representative of Phillips, which is a species of company that has become too rare—that is, the species of company which has survived coercive hostile takeover attempts by corporate raiders.

Before I move into my statement, Mr. Chairman, I would like to correct the record. Mr. Pickens made several false and misleading statements concerning Phillips. In regard to those: First, Phillips did not offer greenmail to Mesa. This was stated to the Ways and Means Committee by our chairman.

With respect to the mismanagement point, I will just give you a couple of statistics. The key statistic in the oil industry as to whether you are doing a good job is whether you are replacing your oil reserves. Now, Phillips in the period 1981 through 1984 more than replaced its worldwide production.

With respect to net income as a percent of shareholders' equity, we were sixth among the 17 largest oil companies, and we ranked fifth in net income per share, and improved our return over this past year.

Now, the third point; that is, whether Phillips is better off with our experience with the raiders—it is compared to what, Mr. Chairman? We believe our shareholders are better off than they would have been if the raiders had succeeded in taking over Phillips. But in respect to whether they are better off compared to our preexisting plans, we do not think so.

Now, moving into my statement.

Senator LONG. Excuse me. Why don't you think so?

Mr. O'TOOLE. Mr. Chairman, we are going to have to be cutting back our exploration budget and our research budget, and we believe that these budgets and the funds that we were going to expend on these were going to deliver long-term value for our shareholders, and we are going to do less of that. The values won't be there.

Our experience over the past several months as a target have made us acutely aware of the coercive junk bond takeover process. We are convinced that this process is fueled in large measure by the current tax laws and that those laws are biased in favor of the corporate raiders and liquidation bust-up takeovers.

The laws are biased against long-term patient money efforts such as research and oil exploration that require equity capital.

We believe this situation undermines the long-term interest of the United States and should be remedied.

Phillips is and always has been a supporter of the free market system, and we have continually emphasized this in our appearances before the Congress.

The free market in this country has enabled Phillips to develop its business over the past 68 years and grow to a position of prominence in the oil and gas industry.

To support the free market principles is not to say, however, that there are not selective abuses fostered by the Tax Code, or that Congress should sanction these abuses by continued inaction. In particular, tax benefits available to corporate raiders of large public companies through the use of junk bonds, and preferential treatment available to recipients of a greenmail, should be addressed by Congress. By now the abusive tactics utilized by corporate raiders have become all too familiar. Typically, a corporate raider will acquire a small interest in a publicly traded corporation. The raider may then make a tender offer conditioned upon obtaining financing. The tender offer for the target shares is usually of a coercive two-tiered variety. In a two-tier tender offer, the first-tier offer is financed by participating debt issued by a paper corporation with nominal assets controlled by the raider. The debt is planned to be assumed by the business operations of the target. The shareholders are usually given a cash premium in the first year of the offer and then in the second tier, after control is gained by the raider, the shareholders will have thrust upon them low-rated, subordinated, high-risk and high-yielding obligations commonly called junk bonds.

Confronted with such a two-tier offer, the shareholder must tender in the first tier or face the risk of being forced to accept a significantly lesser value in the form of lower rated debt in the second tier.

The wide spread between the values offered in the first and second tiers is clear evidence of the coercive nature of the offer. The debt obligations are generally worth far less than the cash offered in the first tier.

If the raider acquires the company, all or part of the company is liquidated by selling assets and siphoning its cash-flow into debt service.

In short, the very attributes of a company that are necessary to protect the long-term values of the shareholders' interest are used to generate the short-term gains of the acquisition.

Sales of assets will largely be sheltered from income tax because of the tax-deductible interest expense on the high-yield securities used to finance the acquisition.

If the raider does not acquire control, he may be able to extract a premium price for his shares from the target, commonly called greenmail, at the expense of the other shareholders.

Your committee has before it several bills that address these abuses. Phillips believes that the bills introduced by Senators Boren and Nickles and a number of their colleagues and the companion bill introduced in the House by Representative Jones will help avoid placing the Treasury in being a silent unwitting partner with these corporate speculators and raiders.

We are aware of your bill, Senator Chafee, and we would hope that any legislation which might result from these hearings would draw on the strengths of both proposals.

In closing, I would suggest that there is probably no member of this committee who feels any stronger than our company's management about the need to keep Government regulation of the marketplace to a minimum. In fact, I have mentioned that Phillips has survived two hostile confrontations. Therefore, it would have been quite easy for us to have declined the invitation to appear here today. But our experiences have told us that if something is very wrong in the free marketplace, that our tax laws are less than neutral.

We had a choice of walking away and letting the Crown Zellerbachs and Union Oil now worry about legislative adjustments. Or we could continue to pursue what we feel is reasonable and appropriate Government policy to address these wrongs.

Senator CHAFEE. Mr. O'Toole, your time is up.

Mr. O'TOOLE. OK. Thank you, Mr. Chairman.

[Mr. O'Toole's written testimony follows:]

Testimony

of

J. W. O'Toole

Phillips Petroleum Company

Before the

Subcommittee on Taxation & Debt Management

of the

Senate Finance Committee

April 22, 1985

Thank you Mr. Chairman. It is a pleasure to be with you today. Phillips and a host of other companies applaud you and this committee for taking the time to examine what, we believe, is a growing abuse of the free market. I am Joseph W. O'Toole, Vice President and General Tax Officer for Phillips Petroleum Company, located in Bartlesville, Oklahoma.

Phillips is an integrated oil company with headquarters in Bartlesville, Oklahoma, where the company was founded in 1917. Phillips operates in 26 countries. Our products and processes are licensed in 31 countries.

Phillips is involved in all aspects of the energy business, including the exploration and production of oil and natural gas, and the refining and marketing of petroleum products. We also have a worldwide petrochemical operation and extensive mineral interest, including lignite coal, oil shale and uranium. We also have developed other alternative energy sources such as geothermal and solar power.

In addition to our energy operations, Phillips has an extensive reserach and development program. We have an organization of more than 1,000 in our R&D staff. Phillips is a perennial leader in the petroleum industry with respect to securing patents.

As you know, Phillips has been the target of two hostile corporate takeover attempts since last December. We have been one of many companies recently targeted by so-called corporate raiders that have been receiving considerable attention in the media, the press, on Wall Street, and in the Congress. We are particularly pleased that the Congress is giving this matter serious attention -- as evidenced by the many hearings that have occured in just the last two months. We have already appeared before four House subcommittees to provide our conclusions of the adverse public policy implications that are emerging from the recent increasing number of hostile corporate takeover attempts. At those hearings we addressed the impact that hostile takeovers can have on employees and communities, philanthropy and research and development. We also addressed aspects of federal law other than the tax laws, such as securities law. All of these important subjects will not be repeated today. Rather, we wish to bring before this committee the tax aspects of certain abusive tactics used in hostile takeover attempts, which we have experienced.

Phillips has been, and remains, a strong supporter of the free market system. The free market in this country has enabled Phillips to develop its business over the past 68 years and grow to a position of prominence within the oil and gas industry. We believe that an economy which operates with minimum government interference is the most productive. Within that free market system, corporate mergers and acquisitions can and do result in appropriate allocations of capital resources. In fact, in recent times, Phillips has been involved in enhancing its oil and gas business through productive acquisitions of reserves. In 1983, Phillips acquired General American Oil Company in a cash merger. In 1984, Phillips acquired Aminoil, Inc. in a cash for stock acquisition. These acquisitions, both of which were friendly, enhanced Phillips' oil and gas reserve positions as well as its oil and gas exploration positions while at the same time leaving Phillips with a substantial equity base. These re-allocations of resources were based on the long term, not the quick profit that could have been realized from liquidating these assets.

But, today professional speculators are utilizing high-risk financial instruments for their own short-term gain at the expense of long-term performance of financially sound and profitable companies.

The issues which this subcommittee and Congress must confront are of vital importance, not only to the several oil companies such as Phillips Petroleum Company, but to many companies in other industries and to the U.S. economy as a whole. Congress must decide whether it wishes, through the tax code and other legislation, to continue to encourage hostile takeover attempts by corporate raiders, or whether to cause the tax code to be neutral for such non-productive actions. As was aptly stated recently by one major U.S. newspaper, "Without Federal legislation, junk bond financing of takeovers is likely to proliferate". (New York Times, April 14, 1985, page 8F)

The arguments most frequently advanced against the enhancement of legislation to limit hostile corporate takeovers are that the securities markets must be allowed to function without additional government interference, that investors and company managers must be allowed to merge resources, that return on shareholders' equity should be maximized and, that shareholders must be allowed to replace inefficient managements. Phillips supports each of these principles. Having said that, I also believe that the type of hostile takeover attempts that have involved Phillips, as well as numerous other companies, are abuses of the free market principle. Moreover, I do not believe that any of the principles I have just mentioned support or justify the disruptive, short-term, profit-motivated actions of professional speculators that are currently driving the rash of hostile takeovers occurring on our economy.

The petroleum industry is a high-risk, capital-intensive, long-term business. If an exploration project fails to find commercial oil or gas reserves, sizeable economic losses may be sustained. A company exploring for new reserves, therefore, must be sufficiently strong to absorb such losses without jeopardizing the shareholders' investments. On the other hand, if exploration succeeds, a discovery probably will require years of heavy cash investment before production begins. For these reasons, the industry must quite often fund new projects from the internal cash flow from current operations. This equity or cash flow funding is necessary to protect the long-term value of the shareholders' investments. Management cannot look solely to short-term gains if it is to meet its responsibilities to shareholders, as well as to the energy needs of our nation.

To underscore my point: Equity . . . or cash flow funding . . . is an important feature of an oil company's capital structure. Substantial amounts of equity are necessary if a company is going to be effective in the oil and gas business. Unfortunately, under the present tax code, the equity component of an oil company's capitalization also makes the company vulnerable to corporate raids.

As I indicated earlier, Phillips itself has become the target of hostile takeover attempts over the last four months. During that period, most of the time and energy of our employees, and the financial resources of the company have been devoted to combating abusive tactics used against us. These tactics have heightened our awareness of the tax benefits involved in hostile takeover attempts. We have become convinced that certain provisions of the tax code need to be revised in order to correct these abuses.

How can it be that corporate raiders are able to acquire a company like Phillips and finance the acquisition almost completely with this so-called "debt"? Typically, a corporate raider will acquire a small interest in a publicly traded corporation. The raider may then make a tender offer conditioned upon financing. The junk bond financing then arranged essentially pledges as security the assets of the target company.

The tender offer for the shares is usually of a coercive "two-tier" variety. In a two-tier tender offer, the offer is financed by this "debt" issued by a paper corporation with nominal assets controlled by the raider.

The shareholders are usually given a cash premium in the first tier of the offer and then, in the second tier, after control is gained by the raider, will have thrust upon them low-rated, often subordinated, high-risk, high-yielding "debt" obligations, commonly called junk bonds. Confronted with such a two-tier offer, the shareholder must tender on the first tier or face the risk of being forced to accept significantly lesser value in the form of low-rated debt in the second tier. The wide spread between the values offered in the first and second tiers is clear evidence of the coercive nature of the offer. The debt obligations are generally worth far less than the cash offer in the first tier.

If the raider acquires the company, all or part of the company is liquidated by selling assets and siphoning its cash flow into debt service. In short, in the case of an oil company, the very attributes which are necessary to protect the long-term value of the shareholders' interests are used to generate the short-term gains of the acquisition. Sales of these assets will be largely sheltered from income tax because of the tax deductible interest expense on the so-called "junk" bonds used to finance the acquisition. Because gains in the transaction are largely sheltered by the debt service on highly leveraged junk bond expense, the raider gets a break that is not available to a company interested in continuing for the long term and maintaining its necessary strong equity base. And, if the raider does not acquire control of the company, he can usually sell his shares to the target company at a premium price, commonly referred to as "greenmail", at the expense of all of the other shareholders of the corporation. The raider may then frequently report the greenmail premium received for his shares as capital gain.

Drexel Burnham Lambert, Inc. is a leading proponent of junk bond financing. As described recently in Business Week (March 4, 1985, at page 90):

> "Drexel's 'leveraged' takeover works like this: The buyer sets up a new company on paper. Drexel creates a package of junk bonds to be issued by the paper company once it gains control through a tender offer. Then Milken (Drexel's head of its joint securities trading department)

> and his 125-person staff contact junk-bond investors, seeking advance commitments to buy the bonds. Once in control, the raider can raise cash by selling off pieces of his new property 'We take a minnow, identify a whale, then look to its assets to finance the transaction', explains Michael D. Brown, Drexel's West Coast merger chief."

Thus, the minnow, having aquired the whale, cuts out its heart in order to finance the transaction. Because gains in the transaction are largely sheltered by the high leverage junk bond expense, the raider obtains tax write-offs that are not available to a company interested in continuing for the long-term and maintaining its necessary strong equity base. These abusive tactics should not be fostered by the tax code. Their curtailment should be directed at hostile acquisitions because this is the source of the problem.

The recent use of these highly leveraged junk bonds in hostile corporate raids . . . which are legitimized by some major investment bankers and subsidized by our government . . . is the distinguishing feature separating abusive hostile takeovers from all other corporate mergers and acquisitions.

Greenmail arises only in the hostile context. Congress, over the objections of many, enacted golden parachute rules that some have described as the equivalent of "management greenmail". There is no reason not to impose a similar excise tax for the receipt by special transient shareholders or groups of shareholders borrowing on the dissected values of a business and then bailing out of the corporation and leaving the remaining shareholders in the lurch.

As I've said, the raider's objective is to acquire control of the company and distribute the equity on tax-favored terms. This is accomplished by the sale of assets and the diversion of clash flow to debt service and short-term gain -- and away from long-term projects. For an energy company, this implies less exploration . . . less development drilling . . . and less research; not exactly in the shareholder's long-term interest. And neither is it in the long-term interest of this country.

I should note an important point here, Mr. Chairman. And that is that the problems we see with these types of hostile takeovers are not limited to the oil industry -- although oil companies have been prominent targets and have dominated the early media and press stories. Hostile raids, utilizing junk financing are aimed at companies in the timber, communications, entertainment, manufacturing and resort hotels industries, to give some examples. Junk bonds for these raids now total in the many billions of dollars.

We believe that Senate Bill 476, introduced by Senators Boren, Nickles and a number of their colleagues, would help bring an end to this abusive practice by denying the interest deductions for high-risk financial instruments when utilized to acquire another company as a hostile acquisition.

This approach will help avoid placing the U.S. Treasury in the position of being a silent partner with these speculators. And, I strongly believe that none of the free-market principles I referenced earlier are compromised or impinged upon by this legislation.

The Boren legislation builds on, refines and clarifies concepts introduced in the Tax Reform Act of 1969. Then, Congress was confronted with the task of distinguishing equity and debt in an acquisition context. In what became section 279 of the Code, congress limited the deduction for interest on certain debt securities which provided a "special and unwarranted inducement to mergers". Interest deductions were disallowed on the use of certain convertible subordinated bonds in corporate acquisitions. Today, the security utilized in the hostile acquisition is rarely a convertible debt security. Rather, the vehicle today is "junk" bonds. Senator Boren's bill is a focused attempt to adapt current law and congressional policy to fit current circumstances. These high-yield securities arising from hostile takeover attempts, because of their low status in relation to other debt of the corporation and because of the virtual disappearance of conventional equity typical in the transactions we are discussing (Mr. Icahn proposed debt of over $11 billion in equity of $800 million, a debt-to-equity ratio of roughly 14 to 1), should not be regarded as bonafide debt under the tax code. In substance, "equity" distributions by a corporate raider (in the form of high-yield bonds) should not be accorded tax deductible interest expense treatment, enabling the raider to shelter gains on the sale of assets that could not be sheltered if the instruments used to finance the transaction were characterized consistent with their true nature.

The equity nature of these securities is apparent. As was recently stated (New York Times, April 14, 1985, page 8F),

> ". . . after a cash tender offer gives control to an acquirer, the buyout can be structured so that the remaining stockholders receive junk bonds of a lower quality or preferred stock, which is junior to any debt obligations. While the value of those securities may be equal to the cash received in the first portion of the tender offer, those securities are at the bottom of the totem pole: when it comes to collateral, they are behind most securities received by the original commitment group." "In the event of bankruptcy, for instance, bank debt, senior bonds and notes and common stock have the first call on assets, ahead of most junk securities paid out to shareholders of the takeover company."

Thus, the junk bonds are virtually on a par with common stock -- at the "bottom of the totem pole".

S. 476 also builds upon a provision introduced in the Tax Reform Act of 1984. There, Congress enacted legislation to impose an excise tax on recipients of golden parachute payments. A logical corollary to the policy behind the golden parachute rules is to also impose an excise tax for special payments made to allow one shareholder or a special group of shareholders to receive special benefits at the expense of other shareholders.

We are also aware of Senator Chafee's legislation on this subject, S. 632. Phillips commends the Senator for recognizing the need to address these abusive greenmail and financing practices. Senate Bills 476 and 632, while not identical, do approach these problems in a similar manner and we would hope that any legislation which might result from these hearings would draw on the strengths of both proposals.

So . . . what can be done to end this partnership between the tax code and the corporate raiders? It is our hope that these hearings will help Congress understand the real nature of these abusive transactions and that this committee will conclude, as Phillips has, that a legislative remedy is needed to address these abuses of the free market.

Mr. Chairman, thank you for the opportunity to allow me to share my thoughts with you today.

Senator Chafee. We want to get to Mr. Bretherick, but Mr. Norris, you have to go.

You heard the arguments of the panel before you, that the stockholders are big boys who can make their decisions, and "let the stockholders decide; after all, if the stockholders are going to benefit, that's what it's all about." What is the matter with that argument?

Mr. Norris. Well, that argument belies the need for management. In fact, there is an enormous difference among companies—some companies are at the leading edge of innovation, working to improve the competitive position of the United States in world markets. A stockholder is not in a position to judge how soon these long-term investments pay off. So I think that would be devastating to American industry, to sort of put everything up to the stockholder.

Senator Chafee. But that is what our whole system is about—we permit people to make decisions, and individuals. And in the legislation that I have introduced, for example, it puts the decision as to what's a hostile takeover in the hands of outside directors. But Mr. Pickens makes the point that directors are all too often captives of management, that management appoints the directors and the stockholders really don't elect the directors in truth. It seems to me the directors are all chosen—at least in any corporations I have ever dealt with, who asks you to be a director? The president of the corporation comes up and says, "Will you be a director?" And you say, "Sure."

Mr. Norris. Well, maybe 50 years ago that argument would apply. But today, believe me, outside directors are very keenly aware that they are liable to lawsuits. So they don't make decisions that necessarily are going to support the chairman; they make decisions on the basis of what is right, taking into account first of all, and certainly to a great extent, the shareholders, but also their other constituents. They try very, very hard to balance those.

So, I think it is inaccurate to say that outside directors are captives of management.

Senator Chafee. Do you have any questions of Mr. Norris, who has to go?

Senator Long. No; Mr. Chairman.

Senator Chafee. How about the argument that Mr. Jacobs made, I think, that a well-managed corporation that is on the cutting edge of technology, its stock will be high in anticipation of future payouts? That the innovative corporations' stock stay up there? And it seems to me that the price-earnings ratio of some of the innovative companies has been extremely high.

Mr. Norris. That is true, Mr. Chairman, if all their leading-edge innovations work out. But in the event they misjudge, which is very easy to do, the length of time that it takes to reach a certain objective, their earnings fall off and then they become a victim to a takeover.

I think Mr. Jacobs' companies are not engaged in the leading edge of innovation. And I think there is a great difference among companies.

Senator Chafee. One of the problems we have, of course, is deciding what is a "junk bond," and what is a hostile takeover. It was pointed out here that junk bonds—I guess Mr. Pickens said this, and I just assume this is accurate—are widely in use. The point was that something like 7 or some tiny percentage of corporations in America whose bonds are listed as top-grade bonds, that all of the rest of the companies who issue bonds, they would be, in effect junk bonds, and so therefore any small company starting out indeed would have to have junk bonds, that that is the way you get started if you can't get venture capital.

Mr. **Norris**. Yes; but these small companies are not dealing in billions of dollars. I know about junk bonds starting Control Data. We are talking about $100,000. So there is an enormous difference with respect to the amounts that are under consideration.

Senator **Chafee**. I see. OK. Well, thank you very much, Mr. Norris, for coming. I know you have been active in this, and we will stay in touch with you in the future on it.

Mr. **Norris**. Thank you, Mr. Chairman.

Senator **Chafee**. We appreciate your being here.

Mr. Bretherick, why don't you proceed?

STATEMENT OF JOHN H. BRETHERICK, JR., PRESIDENT, THE CONTINENTAL CORP., NEW YORK, NY

Mr. **Bretherick**. Thank you, Mr. Chairman, and thank you and other members of the committee for the opportunity to express our views.

I am president of the Continental Corp. Our chief executive officer Jake Mascotte was unable to be here today, so he has asked me to file his statement and to extend to you his apologies.

You have heard this morning a number of views concerning recent trends in mergers in corporate America, some of the suggested reasons and the questions concerning the benefits as well as who benefits.

The issue of taxes and their impact on these events in the insurance business is the subject of my comments today. Specifically, I think I will address your question to Mr. Pearlman.

Continental is one of the few remaining independent underwriters of property and casualty business in every one of the United States. Out of the 25 largest property and casualty insurers, more than half are owned by large life companies or noninsurance companies. Two of the largest takeovers in recent years involve property and casualty insurance companies.

The Internal Revenue Code adopts a State regulatory accounting system—that is, statutory accounting—as the basis for measuring taxable income of property and casualty insurers.

To emphasize insurer solvency and protect policyholders, statutory accounting defers the recognition of income and stresses immediate recognition of potential underwriting losses as well as expenses. Consolidated tax returns allow the results of property and casualty statutory accounting to be transferred to life insurers and noninsurers. The tax credits generated by the property and casualty statutory-type accounting are more valuable in the hands of a nonproperty casualty company, both the life companies as well as the nonlife companies.

Whatever Treasury may think about the merits of statutory accounting for property and casualty insurers, there is no doubt in our minds that Congress never intended that this would be part of the process for determining taxable income of noninsurers or life insurers.

Transfer through a consolidated return of property and casualty statutory accounting can result in a permanent change in a consolidated group's effective tax rate. It is not a question of degree or of timing.

Furthermore, there is no method for recapturing the permanently sheltered income.

A minimum tax is not an answer to this problem. The minimum tax would simply generate far less revenue than a consolidated group can shelter with access to property and casualty statutory results or accounting.

We request that you include as a part of any legislation resulting from these hearings repeal of the ability of nonproperty and casualty companies to consolidate their taxable income with property and casualty losses. If this situation is not addressed, there may not be any independent property and casualty insurers left.

You might ask if this is important. Well, we strongly believe it is. We direct your attention to recent bankruptcies of two large consolidated groups which acquired insurers. As a result, 165,000 policyholders are now stranded awaiting some resolution. Assets that were held in insurance reserves to pay policyholders were drained and replaced with unmarketable investments in affiliated companies.

Thank you very much again for the opportunity to present our views, and I will be happy to answer any questions.

[Mr. John P. Mascotte's written testimony follows:]

STATEMENT BY

JOHN P. MASCOTTE
CHAIRMAN OF THE BOARD
AND CHIEF EXECUTIVE OFFICER
THE CONTINENTAL CORPORATION

CONCERNING
TAX ASPECTS OF MERGERS AND ACQUISITIONS

HEARINGS CONDUCTED
BY THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT
OF THE COMMITTEE ON FINANCE
UNITED STATES SENATE

APRIL 22, 1985

Continental
Insurance.

Senator Chafee, other distinguished members, I appreciate the opportunity to offer these comments on behalf of The Continental Corporation, one of America's largest independent property-casualty (p-c) insurers.

I would like to bring to your attention those provisions of the Internal Revenue Code considered in the takeover of a p-c company -- the consolidated return provisions of the Code and the deemed asset purchase provision of the Code (i.e. Section 338).

A p-c company generates large tax losses which often exceed its economic losses. This phenomenon is a function of state regulatory accounting adopted by the tax law and the exemptions offered by the Code to all p-c companies. Under state regulatory accounting, a p-c company defers income receipts and deducts immediately the expenses in earning that income; in addition, a p-c company deducts in advance its estimate of losses incurred and its estimate of what settlement expenses will be. In this connection, a p-c company also has the option of investing its reserves for unearned income, losses and expenses in securities which yield tax sheltered income, i.e., tax exempt bonds and stocks.

The tax accounting rules for p-c companies have as their underlying purpose the preservation of the solvency of p-c companies which, incidentally, is also the state regulatory purpose. In this manner, the interests of all policyholders is protected, moreover, the Treasury is protected as long as other parties cannot avail themselves of the p-c statutory accounting rules to utilize otherwise unutilized tax losses.

The delicate balance between protecting policyholders and the Treasury is destroyed when others can avail themselves of the tax accounting rules applicable to p-c companies. This can occur when a non p-c company acquires a p-c company and files consolidated returns to utilize its losses, losses that a non p-c company could not otherwise generate as under state law it cannot operate a p-c business directly. Indeed, the non p-c company will pay for the future tax benefits to be generated from the target p-c company. These tax benefits can be multiplied if a Section 338 election is made with respect to the target p-c company.

A Section 338 election can multiply the tax benefits of the target p-c company because the economic profit inherent in the existing reserves of the p-c company can be turned into a tax deduction even though a substantial portion of that economic profit may be attributable to future tax sheltered income. Just for one large acquisition the loss to the Treasury over a period of time on account of the consolidation and Section 338 election rules can amount to several hundred million dollars.

The obvious tax incentives in acquiring a p-c company can lead to acquisitions that are not economic. The acquisition history of Baldwin-United and its ultimate downfall is a case in point. Other acquisitions where the tax rules played an important role are well documented and are a matter of public record. Indeed, today more than one half of the largest p-c underwriters are owned by non p-c companies. See Exhibit 1. An interim Treasury study due in July of 1986 will demonstrate how badly the fisc is effected just by consolidation with life companies. When one considers the benefits non insurance companies obtain under the consolidation - Section 338 rules, it is apparent that corrective legislation eliminating these rules is necessary.

EXHIBIT ONE

The following list illustrates the consolidated groups which are affiliated with more than half of the 25 largest p-c insurers:

1. State Farm [affiliated with State Farm Life]
2. Allstate [owned by Sears, Roebuck, affiliated with Allstate Life]
3. Aetna Casualty & Surety [affiliated with Aetna Life]
4. CIGNA [the company created by the acquisition of INA by Connecticut General Life in 1982]
5. Travelers [affiliated with Travelers Life]
6. Farmers [independent]
7. Continental [independent]
8. Liberty Mutual [independent]
9. Hartford Fire [owned by ITT]
10. Fireman's Fund [owned by American Express, affiliated with IDS Life]
11. Nationwide [affiliated with Nationwide Life]
12. U.S. F & G [independent]
13. Crum & Forster [bought by Xerox in 1983]
14. Kemper [independent]
15. Home [owned by City Investing]
16. St. Paul [independent]
17. AIG [independent]
18. Commercial Union [independent]
19. CNA [owned by Loews and affiliated with CNA life companies]
20. Royal [independent]
21. Chubb [independent]
22. USAA [independent]
23. Prudential [owned by Prudential Life]
24. American Financial [an insurance holding company with both life and property-casualty subsidiaries]
25. Reliance [bought by Leasco, now Reliance Group].

Senator Chafee. Well, thank you.

I have a question for Mr. Creson.

Mr. Creson, you have done a good job, you have run a good company, there is a lot of value in your lands. Most of your stock, I presume, is held by sophisticated investors—pension funds, trusts, retirement funds, and so forth. So, therefore, aren't they smart enough to know as much as Mr. Goldsmith knows, and thus hang on to your stock?

Mr. Creson. Well, of course, the idea that our traditional shareholder base is still in effect is probably inaccurate at this point, because part of the dynamics of this so-called game that's the vernacular used to describe this is that once a raider like Goldsmith comes in and announces a public position and causes values in our stock to go up—and, incidentally, our stock, before the turnaround in our company really started becoming effective, was selling as low as under $16 a share, and last year before Goldsmith entered our situation, our stock was selling typically at more than double that—but when he announced his interest in us and started buying the shares, the price of the stock moved from around a $30 range up to a $40 range, and he announced an offering, a partial conditioned tender offer. I think that is very important, because he has not offered to buy all of the stock and to deal with all of our shareholders on the same terms simultaneously. But what he does is create a dynamic where our traditional sophisticated shareholder base says: "There is a certain risk here. Goldsmith may not hold up, or Crown Zellerbach's management may be such a bunch of wimps that they will pay him greenmail, and he'll take his profit and leave, and the stock will fall back down," which was the case with St. Regis, which simply opened the door for a second and subsequently a third greenmailing attempt on them.

But the traditional shareholder—the pension fund, the money managers, the insurance companies—they say: "We will sell at this point in time." And, in fact, since around March 10, more than a third of our shares have traded on the New York Stock Exchange—over 10 million shares.

Senator Chafee. Who buys it? The arbitrage people?

Mr. Creson. Exactly. So, that, as far as we know, the second largest owner of our stock today is Ivan Boesky. And Ivan Boesky is perhaps the classic risk arbitrageur. He has come in and purchased his stock at what appears, from the public disclosures, a price of around $40 a share, on average. Mr. Goldsmith owns his holding at an average price of something between $33 and $35 a share.

Now, Boesky is highly motivated to see that a transaction takes place, because he has taken on the ownership that was traditionally held by the institutions and other long-term buyers. And so there has been a major shift in the time perspective of those who now own our stock.

Senator Chafee. But isn't the problem that the stockholders aren't smart enough out there to recognize the underlying value of your shares? As you mentioned, stockholders know price, but they don't know value. And the problem with America, apparently, is that stockholders don't see the great value of these forest lands you have got out there.

Mr. CRESON. Well, I think this is the basic problem that is created by external events. That applies not only to forest products but to minerals and to natural resources in general. After all, we came through a period of the 1970's, particularly in the latter part of the 1970's, of an economic scenario of relatively high inflation rates and relatively low real interest costs. And there was value. It was practically a no-brainer to make money by simply holding these resources. In fact, trees, which grow as you keep them in inventory, were very appealing.

Some place the dynamics of our economic system have shifted in the early 1980's, and we are now in a long-term secular trend of relatively low inflation rates and relatively high real interest costs. So, the holding costs and the holding values have changed.

Now, at any moment in time somebody has to make a judgment: Where will those cycles come back? And we believe that in the growth period of timber and other resources, that we are dealing with long-term cycles, and we need to attract a shareholder base who value those long-term cycles and see opportunity there, just as Jimmy Goldsmith does.

Senator CHAFEE. All right.

Senator Long.

Senator LONG. I will ask you a question, Mr. O'Toole.

With reference to the proposed takeover of Phillips, how did that matter work out? Did Phillips borrow a lot of money in order to buy its own stock?

Mr. O'TOOLE. We actually issued debt securities, Mr. Long, and we did not issue any cash. We exchanged 4.5 billion dollars worth of debt securities with our shareholders for about 72 million of their shares. So, we now have interest. We have debt on our books; whereas, before we had equity.

Senator LONG. So, basically, you borrowed a lot of money and bought a lot of your own stock?

Mr. O'TOOLE. Right. We borrowed it, basically, from the shareholders. We gave them debt securities for their shares.

Senator LONG. I am just trying to get this straight in my mind. Take the average shareholder. By the time you get through with all of this, is he in a better position, even or in a worse position?

Mr. O'TOOLE. Mr. Long, there is no question that he realized an immediate uptick in the value of his shares. We issued 62 dollars worth of debt securities for about half of his shares, for each one of the shares he has. And before the stock was selling in the mid to high thirties to forties. He remains a shareholder in respect to the rest.

Now, when you put both of those together, including the value of the shares which he has today and the $62 per share which he got for about half of his shares, he has about 53 to 55 dollars worth of consideration.

What has happened here is that the shareholders has compromised somewhat the long term in favor of a short-term enhancement in value. And that's what the dynamics of this were.

There is no question that on the short term he benefited; but on the long term we think he would have benefited even more.

Senator CHAFEE. What about this two-tier business? Mr. Pickens said that every stockholder of Phillips could have made out all right except those who were extremely unsophisticated and didn't even listen to the messages that came to them that it wasn't a two-tier offer. Is that accurate?

Mr. CRESON. Mr. Pickens' offer was clearly a two-tier offer, and Mr. Icahn's offer was clearly a two-tier offer. And it happens—I'll use Mr. Aikon's, because I think that is an egregious example. He was offering $60 for——

Senator CHAFEE. Well, let's stick with Mr. Pickens'. I can't get into too many, because our time here is short. Mr. Pickens clearly said that every shareholder of Phillips would receive the price he was bidding. Is that correct?

Mr. CRESON. Yes. I think half of them would have got cash, and the other half would have got debt securities.

Senator CHAFEE. Well, there is a lot of difference between cash and debt securities, though. I thought he made it clear that all were treated the same.

Mr. CRESON. Not so.

Senator CHAFEE. Not so.

All right. Now, Mr. Bretherick, we will followup on the question I asked Treasury earlier—I don't know whether you were here.

Mr. BRETHERICK. Yes, I was.

Senator CHAFEE. About the property and casualty insurance companies' ability to file consolidated returns. Senator Matsunaga had a similar question to that.

Well, gentlemen, thank you very much. As you can see, this is a difficult problem, trying to define junk bonds, trying to define a hostile takeover, whether the outside directors are the ones to have a say in these things, are outside directors truly outside directors, should the interpretation of the Internal Revenue Code be left to outside directors instead of having something set forth in the law. All these are very difficult.

Thank you for coming.

The final panel is Mr. Andersen, managing director of corporate finance for Drexel Burnham; Mr. Maher, First Boston and Prof. James Eustice.

Why don't you come right up, gentlemen? Mr. Andersen over to the left, if you would, Mr. Maher in the middle, and Professor Eustice in the end.

All right, Mr. Andersen, go right to it. I will put your statement in the record. Why don't you just summarize it, if you would.

Mr. ANDERSEN. I would like to try.

STATEMENT OF G. CHRIS ANDERSEN, MANAGING DIRECTOR, CORPORATE FINANCE, DREXEL BURNHAM LAMBERT, INC., NEW YORK, NY

Mr. ANDERSEN. Thank you.

I appreciate the opportunity to present the views of Drexel Burnham Lambert, Inc., concerning certain economic and tax policy considerations with respect to the current acquisition environment and high-yield bond financing of acquisition activity.

For the convenience of the committee I will summarize my statement, and the full text will be included.

Drexel is one of the leading investment banking firms and has played a major role in the development of the high-yield bond market. High-yield bonds include all issues rated Ba1 or lower, and generally bear interest at rates in excess of those on investment-grade bonds.

High-yield bonds have been dubbed, pejoratively, "junk bonds," an appellation originally describing the debt securities of troubled companies. Typically, these bonds were originally issued as investment-grade securities but were subsequently downgraded by the rating agencies when their respective issuers suffered business downturns. In the financial community these bonds were referred to as "junk" to reflect the fallen fortunes of the issuers.

When bonds are downgraded they trade at discounts. Frequently, however, downgraded companies, or fallen angels as we call them, are able to overcome their difficulties, and their ratings are commensurately upgraded. When this happens, investors who purchased at a discount will realize an economic gain.

Over the years, Drexel developed the analytical techniques to sift through this junk heap and identify undervalued companies and companies with real growth potential. By selling these bonds to sophisticated individuals and institutional investors, Drexel began to develop the market for high-yielding securities.

Drexel quickly recognized that the same techniques used to analyze fallen angels could be applied to analyzing emerging growth companies which do not yet qualify for investment-grade ratings. These companies receive low ratings from Moody's and Standard & Poor's because of their size and their short credit history.

In recent years, Drexel has significantly expanded the high-yield bond market by underwriting public debt offerings and by trading bonds issued by these companies. We refer to this component of the market as the rising stars.

It is important to note that over 85 percent of all public U.S. companies, if they were to apply for a rating, would be rated below investment grade. The companies in this segment include many of our most rapidly growing and innovative enterprises. Examples of these companies in this segment include MCI, Harte-Hanks Cable, Middle South Energy, Pennsylvania Power & Light, Six Flags Corp., Occidental Petroleum, et cetera. This segment of our corporate world has been responsible for 80 to 90 percent of all the job formation in the United States. Certainly, these companies cannot be considered junk. It is from this sector that many of tomorrow's industrial powerhouses will emerge.

I think that one of the key issues here is: What is a junk bond? And to put this into perspective. We have used the notion that it is pejorative. I would like to read, if I could, some excerpts from a speech that was given by a money manager to the New York Society of Securities Analysts recently in New York.

Senator CHAFEE. Well, feel free to read it, but you have a limited time. So, it is all within your time.

Mr. ANDERSEN. I understand. I think this will crystallize what a junk bond is.

Most of the time the anxiety of high-yield investing is overdone. Sometimes the anxiety is not justified at all. Think about the high-yield issuers with whom you deal every-day. Think about the enduring values of their businesses because of your personal patronage. Think about the managements who are working to improve the credit ratings of their companies—not working just to maintain a single, double, or triple A, but working to create a single, double, or triple B credit, and not working just to make money.

You are here in New York City. Ten years ago the city was going bankrupt. A large building down the street was adjudicated valueless because there was no future in this city or in its real estate. Credit upgraded.

The room in which you are sitting is heated and cooled by Con Edison—a notoriously bad credit. Another company once near bankrupt—another upgrade.

If you came here by bus or subway, the provider was New York State, another high-yield issuer whose credit has been highly suspect.

If you came by car, you might have been in a Chrysler or an American Motors, or a Ford. The tires on the car you rode were certainly from a high-yield issuer, whether it was Armstrong, Firestone, Goodyear, Goodrich, or Uniroyal. The fuel power in your car came from Amerada Hess, Cities Service, Dome, Phillips. And perhaps you parked in a Kinney lot.

If you came by train, you came over Penn Central or New Haven. If you came from the Midwest, you might come by Chicago-Pacific, The Milwaukee Road, Chicago Northwestern, Illinois Central, Western Pacific. Regardless of the line, you probably rode on ACF wheels, and if you saw the freight moving it was in CTI/Gelco containers.

It is virtually impossible to get transportation in the United States without flying high-yield—American Airlines, Continental, Eastern, Muse, Pan-Am, People, Republic, TWA, United, U.S. Air, Western, World. They are all high-yield issuers.

And don't forget that the Monogram Division of Nortech made the toilets in those aircraft. [Laughter.]

When you were working, you probably were wearing clothes purchased by the high-yield issuer Carson Pirie Scott, Higbees, or Montgomery Ward. Your BVDs are from Northwest Industries. Your suit is from Palm Beach, Inc. Your tie is from the Bert Pulitzer's Division of McGregor's. Your shoes are from Johnston and Murphy Division of Genesco.

When you are dining, you are eating high-yield food—olives from Early California Industries, beef from Occidental, bananas from United Brands, pineapples from Castle and Cook. Allegheny Beverage, Trans World, ARA, Collins Food, and Horn and Hardart may have served you.

When you watch Channel 11 in your room, you are watching RKD Gencorp, Metromedia, CNN News from Turner Broadcasting. These were produced by Cannon, Lorimar, MGMIUA, Orion, Paramount, Twentieth Century Fox, and Warner Brothers. Josephson International represents many of the stars put in front of you. They are all high-yield issuers.

Since your reception might not be good, you probably are connected to cable. The cable box might be from Oak Industries.

Senator CHAFEE. All right.

Mr. **Andersen**. I think you might see that 85 percent of the people in the United States work for junk companies.

Senator **Chafee**. That is, if those companies issue bonds. Do they?

Mr. **Andersen**. All of those companies are companies that have issued bonds.

Senator **Chafee**. All right, fine. Well, thank you very much.

Mr. Maher.

[Mr. Andersen's written testimony follows:]

Drexel Burnham Lambert

Drexel Burnham Lambert Incorporated
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STATEMENT OF G. CHRIS ANDERSEN, MANAGING DIRECTOR
OF DREXEL BURNHAM LAMBERT INCORPORATED
BEFORE THE SUBCOMMITTEE ON TAXATION & DEBT
MANAGEMENT OF THE SENATE FINANCE COMMITTEE

Mr. Chairman and Members of the Subcommittee:

I appreciate the opportunity to present the views of Drexel Burnham Lambert Incorporated concerning certain economic and tax policy considerations with respect to the current acquisition environment and high yield bond financing of acquisition activity.

I. Overview

Drexel, one of the leading investment banking firms, has played the major role in developing the high yield bond market. High yield bonds include all issues rated Ba1 or lower (Moody's) or BB+ or lower (Standard & Poor's) and generally bear interest at an above-market rate.

High yield bonds have been dubbed pejoratively "junk bonds," an appellation that originally described debt securities of troubled companies. Typically these bonds were issued originally as investment grade securities, but were subsequently downgraded by the rating agencies when the respective issuers suffered business downturns. In the financial community, these bonds were referred to as "junk" to reflect the fallen fortunes of the issuers.

When bonds are downgraded, they trade at a discount. Frequently, however, downgraded companies, or "fallen angels" as we call them, are able to overcome their difficulties and their ratings are commensurately upgraded. When this happens, investors who purchased at a discount will realize an economic gain. Over the years, Drexel developed the analytical techniques to sift through the "junk heap" and identify undervalued companies, and companies with growth potential. By selectively selling these bonds to sophisticated individual and institutional investors, Drexel began to develop the market for high yield securities.

Drexel quickly recognized that the same techniques used to analyze "fallen angels" could also be applied to analyzing emerging growth companies which do not yet qualify for investment grade ratings. These companies receive low ratings from Moody's or Standard & Poor's because of their size or short credit history. In recent years, Drexel has significantly expanded the high yield bond market by underwriting public debt offerings and by trading bonds issued by these companies. We refer to this component of the market as the "rising stars."

Over 85% of all U.S. public corporations, if they were to apply for a rating, would be rated below investment grade. The companies in this segment include many of our most rapidly growing and innovative enterprises. Examples of companies in this segment include MCI, Harte-Hanks Cable, Middle South Energy, Pennsylvania Power and Light, Six Flaggs Corporation and Occidental Petroleum. This segment has been responsible for 80%-90% of all job formation in the United States. Certainly the debt of these companies cannot be considered "junk." It is from this sector that many of tomorrow's industrial powerhouses will emerge.

U.S. companies rated below investment grade have used high yield debt to raise much needed financing through the capital markets. Before the development of a market for high yield debt, these companies were denied access to the public capital markets and had to rely on financing available through banks and insurance companies. High yield bonds are a more flexible alternative to these "traditional" forms of financing. Thus, the high yield bond market has grown substantially as a result of companies' preferring high yield debt to traditional financing as a method of raising capital and investors' attraction to high yield instruments. Insurance companies, mutual funds, individuals, pension funds, savings institutions and other sophisticated investors purchase high yield bonds to receive the substantial interest rate premiums available from these securities. These investors have recognized that these premiums more than compensate for the risk of default.

High yield bonds have received widespread publicity not only for their importance as a method of raising capital but also for their role in the financing of acquisition activity. Unfortunately, high yield bonds have become the subject of certain legislative proposals which seek to discourage acquisition activity by denying the deductibility of interest on debt. In Drexel's view, these proposals are not based on sound economic or tax policy.

Drexel agrees with the many experts who have concluded that merger and acquisition activity results in a number of economic benefits, including the shifting of assets to more productive uses, more efficient forms of distribution and technology transfers that promote new research and development. Acquisitions also expedite the restructuring of unsuccessful conglomerates into more efficient and more valued entities. Acquisition activity serves to spur management to strengthen company performance and may result in the replacement of ineffective management. For example, the chief executive officers of Walt Disney Productions, Martin Marietta Corp. and Phillips Petroleum Company, while they vigorously opposed takeover attempts, have nevertheless acknowledged that acquisition attempts on their companies have forced management to become more disciplined.

Furthermore, as many scholarly studies have demonstrated, tender offers result in substantial gains to shareholders of target firms and also benefit shareholders of bidding companies. In this regard, acquisitions cause transfers of wealth to shareholders who normally reinvest the proceeds in the capital markets or purchase goods and services, thereby in either case stimulating economic growth and making money available for investment.

The Williams Act strikes an equitable balance between targets and acquirers that allows the market to operate efficiently. There is no evidence that the overall balance between acquirer and target has been upset in recent acquisition activity. Congress should not disrupt the current balance maintained by the securities laws through a modification of the Internal Revenue Code.

As I have indicated, Drexel believes that mergers and acquisitions are valid business strategies which spur economic growth and productivity. Acquisitions are motivated by legitimate business objectives, such as achieving better allocations of resources, substituting new management teams and maximizing other business and economic opportunities. These advantages result even where the objective of a change in control is liquidation of a part of the target's assets. Those transactions almost invariably result in such assets being transferred to stronger or more aggressive managements which more efficiently employ the divested assets. In our experience, tax considerations become relevant only in determining the structure of a transaction which is engaged in for non-tax reasons, and are not necessarily the controlling consideration with respect to structure.

High yield debt has made an important contribution to acquisition activity by making capital available to finance acquisitions of the largest companies. Previously, sheer size had prohibited economically advantageous acquisitions because of the amount of capital required to finance such transactions. Under recent proposals that would deny the interest deduction with respect to high yield indebtedness, acquisitions would be practically limited to large companies which are able to borrow the money from banks or by issuing commercial paper -- transactions which would be entitled to an interest deduction. Smaller growth companies, which are often a great source of new ideas and more vigorous management, would not be able to afford to offer the same or better prices as large acquirers which can obtain bank financing and deduct interest payments. Thus, such legislation would, in a discriminatory fashion, reduce competition in acquisitions and thereby deny shareholders the opportunity to receive the best premium for their shares.

II. Recent Tax Initiatives

Drexel also submits that the tax proposals (collectively the "Proposed Bills") being considered by this Committee are in conflict with important principles which our federal tax system should seek to promote. As more fully discussed herein, the Proposed Bills are contrary to such principles in the following respects:

The Proposed Bills represent an attempt to use the tax system to further non-tax policies, and are therefore inconsistent with the principle of neutrality in taxation.

The Proposed Bills would treat similarly situated taxpayers in different ways, and are therefore inconsistent with the objective of "horizontal equity."

The Proposed Bills would give a substantial advantage to wealthier taxpayers, and are therefore inconsistent with the objective of "vertical equity."

The Proposed Bills represent an attempt to oversimplify an extremely complex issue, and, like any oversimplification, will result in distinctions that make little economic sense.

Any attempt to deal effectively with that complexity through detailed statutory rules is likely to be unsuccessful and, in any event, will result in additional complexity in an already complicated area of the tax law.

The Proposed Bills would result in important decisions as to a taxpayer's status being made by third parties.

A. BACKGROUND

Since the inception of the income tax over seventy years ago, our federal income tax laws have always permitted a deduction for the payment of interest. Our income tax system is based on the concept of net income, and the cost of borrowing money is a fundamental factor in determining a taxpayer's net income and, hence, ability to pay the tax. Except in limited circumstances where the allowance of an interest deduction produces a distortion in the taxpayer's income,* the tax law has generally ** not sought to use the interest deduction as a means to discriminate in favor of or against the use of borrowed funds for particular purposes. It has properly, and wisely, left decisions on the use of credit to market forces, which serve as a much more powerful brake on the improvident use of debt financing. Moreover, even those proposals to limit the deductibility of interest on debt incurred for personal purposes have recognized that when debt is incurred in a trade or business or for the production of current income, the cost of carrying such debt is entitled to the same deduction as any other business expense. See, e.g., Treasury Department Report to the President on Tax Simplification and Reform, November 27, 1984, at 83.

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* See, e.g., Section 265 of the Internal Revenue Code of 1954, as amended (the "Code"), relating to interest on debt incurred to carry tax-exempt bonds; Section 163(d) of the Code, relating to interest on debt incurred to carry investments not generating current income. Except where otherwise stated, all section references herein are to the Code.

** Section 279, discussed at greater length below, is an example (and an unsuccessful example) of an attempt to manipulate acquistion structuring by means of tax policy.

The one area in which the tax law has drawn a distinction regarding the deductibility of interest payments concerns debt instruments which are considered tantamount to an equity interest. Since dividends paid by a corporation to its shareholders are not deductible in determining federal income tax liability, the distinction between debt and equity is a valid and important concern of the tax law. However, even in this area, the distinction has been drawn through the application of uniform, neutral economic principles to the characteristics of the instrument in question. Generally, the courts have focused, on a case-by-case basis, on the actual rights and obligations created by an instrument, in order to determine whether such rights and obligations economically give rise to a debt or an equity relationship. The factors considered by the courts have been applied in a principled, non-discriminatory manner without distinction as to the type of economic enterprise in which the instrument was created. Stock or asset purchases, friendly or hostile acquisitions, all have been judged even-handedly.

The goal of creating objective, universal standards, by legislative decree or through Treasury Regulations, to govern the debt-equity area has proved elusive after years of effort. In 1969, Congress, recognizing the need for guidance in this complex area, but also recognizing that the complexity of the issue made it "difficult . . . to provide comprehensive and specific statutory rules of universal and equal applicability," Sen. Rep. No. 91-552, 91st Cong., 1st Sess. (1969), reproduced at U.S. Code Cong. & Admin. News 2170, enacted Section 385, which authorized the Treasury Department to promulgate regulations governing the determination of whether an interest in a corporation is debt or equity.* No such regulations were promulgated even in proposed form until 1980, when the Treasury Department issued lengthy and detailed proposed regulations. The regulations were issued in final form later that year; however, after several amendments and numerous postponements of the effective date, the Section 385 Regulations were withdrawn in 1983, prior to having become effective. Thus, today, some sixteen years after the enactment of

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* An earlier attempt to provide statutory definitions of stock and debt for certain other purposes had been rejected by Congress on the ground that "any attempt to write into the statute precise definitions . . . will be frustrated by the numerous characteristics of an interchangeable nature which can be given to these instruments." S. Rep. No. 1622, 83rd Cong., 2d. Sess. 42 (1954).

Section 385, no regulations implementing that section are in effect.

At the same time as Congress enacted Section 385, it also enacted Section 279, which provides special rules for distinguishing debt from equity in an acquisition context. Section 279 was an attempt to deal specifically with a narrow class of instruments which give the holder a participation in the equity of the corporation. It deals equally with stock and asset acquisitions, friendly and hostile. In general, Section 279 limits deductibility of interest on debt which is (a) convertible, (b) expressly or actually subordinated, and (c) issued to provide consideration for an acquisition.

B. PROPOSED BILLS

The bills which have been introduced to deny interest deductions on acquisition indebtedness have taken three basic approaches. One basic approach, found in S. 414 (Sen. Nickles), H.R. 1003 (Rep. Jones), S. 420 (Sen. Boren) and S. 632 (Sen. Chafee), would be to deny an interest deduction on any indebtedness incurred in a hostile acquisition. The second basic approach, found in H.R. 1100 (Rep. Jones) and S. 476 (Sen. Boren), would deny such deduction only for "junior debt." For this purpose debt is deemed to be "junior" if either (a) the debt is subordinated, (b) the target corporation (after the acquisition) accounts for more than 50 percent of the issuer's assets, or (c) such debt is rated, by any commercial rating agency, at least two ratings inferior to any other class of debt of the issuer.

Under both of these approaches, a deduction is only denied if the acquisition is hostile -- that is, if it is not approved by the board of directors of the target corporation.

The third approach, found in H.R. 1553 (Rep. Dorgan), would deny an interest deduction on any debt incurred in connection with acquiring control of a corporation with annual gross receipts in excess of $250,000,000, regardless of whether such acquisition is hostile or friendly.

C. DISCUSSION

1. The Proposed Bills Are Inconsistent With the Principle of Neutrality. The goal of neutrality in taxation is based on the premise that economic decisions are best left to market forces and that a sound system of taxation should deal with the consequences of decisions freely made in a competitive market rather than seek to control that market. The introduction into the tax law

of rules favoring some sources and uses of money over others inevitably interferes with the efficiency of that free market and is particularly inappropriate when that interference is intended to serve non-tax policy consideration.

The argument has been made that the Proposed Bills would merely eliminate existing distortions allegedly caused by incentives to engage in acquisitions. However, while the interest deduction may create an incentive for the use of borrowed funds rather than equity capital, it creates no incentive to use such funds for acquisitions, hostile or otherwise, rather than for other purposes. This "incentive" for debt financing is inherent in the distinction between debt and equity and is an integral feature of our tax system. If the issue of deductibility of interest is to ~~be~~ re-examined, it should not be approached on a piecemeal basis.

It also has been argued that denying interest deductions in debt-financed acquisitions merely places such acquisitions on an equal footing with equity financed acquisitions. The unstated assumption of this argument is that debt and equity are completely interchangeable forms of financing and that buyers currently have unrestricted freedom to choose one form over the other. In reality, the financial structure of an acquisition is subject to intense scrutiny by the investors, who would face substantial losses in an over-leveraged transaction. The history of unsuccessful attempts to deal with the debt-equity issue through legislation suggests that such investors are the more effective and reliable regulators of excessive leverage. The decision as to the use of borrowed funds currently is, and should continue to be, made by hard-headed bankers and other lenders whose economic self-interest sufficiently restricts distortive financing practices.

In any event, it is apparent from the structure of many of the Proposed Bills that they are designed not to correct any imbalance in the tax law favoring acquisitions, but rather to protect management from "hostile" acquisitions -- a goal which serves no legitimate tax policy.

2. The Proposed Bills are Inconsistent With the Objective of Horizontal Equity. The principle of horizontal equity is that taxpayers in essentially the same position should be treated the same by the tax laws. Under the Proposed Bills, two corporations can issue the identical instrument, and yet be placed in vastly different tax situations, depending on whether the proceeds of

such instrument are used for an acquisition. From the perspective of tax policy, it should make no difference, for example, whether a corporation wishing to engage in a new business does so by purchasing assets separately and starting such business itself, or by acquiring an existing entity. Yet, the former course of action is not affected by the Proposed Bills, while the latter may be. Indeed, under the Proposed Bills (other than H.R. 1553), even if the two hypothetical issuers use the proceeds for exactly the same purpose -- to acquire identical companies -- they would nevertheless be placed in a different tax situation depending on whether the boards of directors of the respective targets approved the acquisition. This differing treatment of similar taxpayers engaged in virtually the same transaction is clearly contrary to the principle of horizontal equity.

3. The Proposed Bills are Inconsistent With the Principle of Vertical Equity. Under the principle of vertical equity, a tax system should not favor wealthy, high-income taxpayers over those less favorably situated. A large, wealthy corporation which wishes to consummate an acquisition and which has sufficient resources to do so without relying on outside debt financing would not be affected by the Proposed Bills. On the other hand, a

smaller, less wealthy acquirer would be placed at a severe competitive disadvantage.

Those bills which would deny deductibility on "junior" indebtedness are contrary to the principle of vertical equity in other respects as well. Since the definition of junior indebtedness would depend, in part, on the determination of creditworthiness made by the private rating agencies, a large, well-established wealthy corporation with which the rating agencies are familiar has a significant advantage over a younger or less wealthy corporation. In addition, since debt would be deemed junior if (after the acquisition) the target accounts for more than 50 percent of the issuer's assets, with respect to any potential target the bills would create a clear advantage for larger acquirers. The bills denying interest deductions also create potential advantages for foreign buyers capable of borrowing on a tax-deductible basis in their home countries, and for taxpayers who have a surplus of tax deductions and tax credits from other activities, to whom interest deductions are superfluous.

Certainly no considerations of tax policy justify more favorable treatment for larger, wealthier and more well-established corporations or for foreign or tax "sheltered" buyers. Indeed, if any preference is to be shown, it should be for smaller, younger and growing companies, which are both more in need of such protection and are likely to represent the sort of innovative, creative entities which are conducive to economic growth and which should therefore be encouraged.

4. The Distinction Between Debt and Equity Is Extremely Complex, and Cannot Be Adequately Dealt With by Broad Statutory Language. As discussed above, the courts, in distinguishing between debt and equity, have looked carefully at all of the facts concerning a particular instrument to determine whether such instrument more closely resembles debt or equity. Although the courts have looked to various factors in making such determination, it has been impossible to develop any hard and fast rules. In 1969, Congress recognized that the technical and conceptual complexity of this issue made it inappropriate for resolution by statute, and authorized the Treasury Department to promulgate regulations. After sixteen years and several attempts, the experts at the Treasury Department and the Internal Revenue Service, who are certainly familiar with the problems raised by this issue, have been unable to develop workable regulations which, on the one hand, are sufficiently specific to give

guidance, and, on the other hand, are sufficiently flexible to deal with the myriad of instruments which it is possible to create.

This history points up the extremely difficult and complex nature of the problem. To the extent that the Proposed Bills are intended to deny interest deductions on equity-type instruments, it is unrealistic to think that an issue which has baffled courts and administrators for many years can be adequately solved by a simple overly-broad definition. To treat all hostile acquisition debt as equity, to treat "junior" hostile acquisition debt as equity, or to treat all acquisition debt as equity, simply fails to take into account the numerous factors which must be considered if the determination is to bear any reasonable relationship to the actual economic nature of the instrument. Such a system will inevitably suffer from both over- and under-inclusiveness, covering transactions which were not intended to be covered, and excluding other cases which were within the intended coverage of the legislation.

5. Detailed Statutory Debt-Equity Rules are Likely to be Ineffective and Will Create Undesirable Complexity. As indicated above, broad statutory rules are likely to deal with the debt-equity distinction in an

imprecise and haphazard manner. On the other hand, the adoption of detailed rules governing the area is likely to be equally futile, considering the history of the Section 385 regulations. It has been argued that a set of rules governing only the area of acquisitions is a more manageable task. This argument underestimates both the complexity of the current acquistion field and the unlimited potential for new types and forms of acquisition transactions.

It has also been argued that regulation of this area can be achieved with mechanical debt-equity guidelines geared to particular industries. Apart from the obvious problem of defining and segregating various industries, this approach really advocates a revival of an even more elaborate set of Section 385 regulations. The proponents of this idea appear to have drawn the conclusion that the Section 385 regulations proved unworkable because they were not complicated enough. Those regulations did not fail for lack of complexity (or effort) and additional complexity would not appear to provide a solution.

Section 279 also provides an unfortunate precedent for some of the proposals currently under discussion. The ineffectiveness of Section 279 is pointed to as a reason for creating a Section 279 II. An alternative interpretation is that Section 279 is evidence of a failure of conception, not merely detail. It represented an attempt, in a few paragraphs of statutory language, to impose a novel tax policy on one of the most complicated, dynamic, and flexible segments of our investment markets. Its inevitable failure should not be repeated here. We are dealing with an area too involved to be dealt with even using a scalpel and too important to our economy to be dealt with using an ax.

In light of recent support for simplification and greater certainty in the tax system, we submit that, inasmuch as the Proposed Bills will increase the complexity of the tax system, they are not in accordance with sound tax policy.

6. The Proposed Bills Place Decisions as to the Status of a Taxpayer in the Hands of Other Taxpayers. Under the Proposed Bills (other than H.R. 1553), whether indebtedness of one corporation will qualify for the interest deduction would depend on whether another unrelated corporation approves the use of the borrowed funds. In addition, with respect to those bills which would deny the interest deduction on "junior indebtedness," deductibility would depend on the determination of creditworth-

iness made by private rating agencies. In effect, the power to determine the amount of tax payable by a taxpayer, which has historically belonged to the Internal Revenue Service and the courts (and, in a broader sense, Congress) will have been delegated to private interests. Such a delegation is unique in the tax law, and raises fundamental questions of fairness. Surely it would not be considered appropriate for Congress to give a particular private individual, who is unaccountable for his actions, the power arbitrarily to impose a tax on others. In effect, this is precisely what the Proposed Bills would do.

D. CONCLUSION

To the extent that the Proposed Bills represent a use of the tax system to implement a non-tax policy against acquisitions, hostile or otherwise, it is an inappropriate use of the tax system. To the extent that the Proposed Bills are an attempt to clarify the distinction between debt and equity, it is an inadequate and overly-broad solution to a complex problem. The Proposed Bills are inconsistent with long-established principles of tax policy.

STATEMENT OF JAMES R. MAHER, MANAGING DIRECTOR, FIRST BOSTON CORP., NEW YORK, NY

Mr. MAHER. Mr. Chairman, I welcome the opportunity to appear before you today and discuss these important issues.

I have submitted my written statement for the record.

I am a managing director with the First Boston Corp. and have, for the last 8 years, spent almost 100 percent of my time working on various merger and acquisition transactions.

During the course of 1984, First Boston was involved in 130 transactions ranging in value from $9 million to over $10 billion.

I think before you today are really two important questions: One, is there a problem in the tender offer, merger and acquisition area requiring legislative action? And two, and probably more importantly for this committee: If so, are changes in the Tax Code the most effective and least intrusive way to achieve this objective?

I am not a tax expert, but I can tell you from my experience that the driving forces behind the current merger activity are economic and financial considerations, not taxes. And although reform may be timely, the use of tax policy to curb real and perceived abuses is ill conceived.

The tax changes proposed may have a temporary disrupting impact on hostile takeovers, but from my standpoint it is important that you understand what the tax changes will not do.

The tax changes will not stop hostile takeovers, only modify them. Tax changes will not preserve any balance between bidders and target companies, only alter them. And discriminatory tax changes will not further the cause of shareholder democracy, only weaken it and further disenfranchise shareholders.

What tax changes can do is the following:

Tax changes can tip the balance in favor of targets and larger corporations; tax changes can harm shareholders' interest and values without any resulting benefit to them; and tax changes can have a disruptive impact on our capital markets.

Any reform, therefore, must be part of a cohesive system which protects investors, preserves balances between bidders and targets' managements, and doesn't create artificial distinctions.

It is important not to create meaningless distinctions in the Tax Code such as "friendly" and "hostile." Trying to solve nontax problems with the Tax Code is like pushing a balloon—you merely move the problem around. If action is needed for perceived abuses, do it through the securities laws.

If Congress decides to amend tender offer and acquisition laws, look to the securities laws. Even then, you should not intervene unless the amendments are systematic, balanced, and create a rational system. Piecemeal tax reform will not work and will only create other problems.

And even if tax changes are successful in blocking some takeovers, we'll see a shift from cash transactions to possibly proxy fights and other types of transactions.

Finally, I would like to take a moment to discuss the valuation process. Contrary to what some maintain, the Tax Code is not the basis of the spread between market prices and the prices paid for the stock of corporations. Instead, discounted cash-flow analysis is probably the most important part of the valuation process. Generally, in our experience, most people who look at companies come to the same conclusion about value, no matter how they intend to finance it.

All classical valuation models really do not look at the decision of whether you finance an acquisition with debt or equity. Although how one finances an acquisition doesn't impact a valuation model, it may impact the bidder's ability to pay the full value. For example, if the interest payments on acquisition debt are not deductible, it will affect the acquiring entity's ability to realize its projected cash-flow. Accordingly, by using discriminatory tax reform, you may be eliminating the highest bidder from the auction process, and thereby harming shareholders' interest.

Thank you.

Senator CHAFEE. Thank you.

Professor Eustice?

[Mr. Maher's written testimony follows:]

Statement of James R. Maher
Managing Director, First Boston Corporation
before the Senate Finance Committee
Taxation and Debt Management Subcommittee
April 22, 1985

I. Introduction

My name is James R. Maher. I am a Managing Director of the First Boston Corporation, a major investment banking concern, where I am a Director in the Mergers and Acquisitions Group. I have been an investment banker with First Boston since 1976, and a member of its Mergers and Acquisitions Group since 1977. During the past nine years, I have acted as the financial advisor to bidders, targets and third parties in numerous tender offers and merger transactions. In 1984, our department was involved in more than 130 acquisition transactions with an aggregate value ranging in size from $9 million to $10 billion. In my opinion, none of these transactions were primarily tax motivated.

I welcome this opportunity to appear before you to discuss the operation of our capital markets, in general, and more specifically, how and why takeovers occur. The issues you are considering are timely and important. Although these hearings are primarily concerned with how the tax code affects these takeover transactions, I am not a tax expert. However, based on my experience, I would say that while our federal tax system is not perfect, it is largely a neutral factor in the the takeover area.

In your review of the impact of the federal tax laws on takeovers, you should consider two threshold questions.

1. Is there a problem in the tender offer, mergers and acquisitions area requiring legislative action to cure a regulatory gap?

2. If Congress decides to change the law to restrict the number and size of takeovers or the intensity with which certain takeovers are conducted, are changes in the tax code the most effective and least intrusive way to achieve this objective?

Mr. Chairman, in response to the first question, I would like to make the following two points:

> 1. Most of the compelling evidence with which we are familiar argues forcefully that tender offers and mergers are good for shareholders and beneficial for the economy.
>
> 2. Over the last half-century, Congress has created a complex and delicate system of federal regulation that, together with state regulation, has generally been effective in weeding out abuses while maintaining strict neutrality between the various economic interests involved in takeover transactions. These laws permit the market instead of government decisionmakers to determine the most efficient way to allocate resources.

I am not going to tell you that there are not occasional abuses in the field of corporate takeovers, or even that some corrective legislation may possibly be necessary to prevent their recurrence.

However, even if you determine that there is some gap in the regulation of tender offers, mergers and acquisitions, changes in the tax code to rectify the perceived abuses would be ill conceived. Trying to solve all the world's problems by constantly changing the tax code is simply the least appropriate and efficient method to resolve those perceived problems, and would inevitably threaten the neutrality between bidders and targets and jeopardize the health of our capital markets.

As I am sure you are aware, this Subcommittee is not conducting these hearings in a vacuum. In 1983, the Securities and Exchange Commission appointed a distinguished panel to serve as its Advisory Committee on Tender Offers. Almost all of the members of the Advisory Committee were prominent business, legal and financial institution leaders intimately familiar with the tender process, financial markets and corporate governance. The primary premise which the Advisory Committee recommended for the regulation of takeovers was:

> Neutrality and Protection of Shareholders. Takeover legislation should not favor either the acquiror or the target company, but should aim to achieve a reasonable balance while at the same time protecting the interests of shareholders and the integrity and efficiency of the markets.[1/]

During the last session of Congress, the Senate Finance Committee held hearings and issued a report on the effect of the

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[1/] Securities and Exchange Commission, Advisory Committee on Tender Offers, Report of Recommendations xviii (July 8, 1983).

tax law on mergers and acquisitions of oil and gas companies.[2] During this session of Congress alone, at least seven other Committees in the Senate and House have held hearings or are considering bills on mergers and acquisitions. If any legislative action is necessary, we would prefer to see it in the form of systematic reform which directly and narrowly attacks the perceived problems with the process, while preserving the overall consistent structure. Piecemeal intervention in our capital markets through changes in the tax code is like pushing on a balloon -- you are merely moving the problem around without solving it.

II. Today's Merger Activity

A. Mergers are Capital Transactions Based on Economic Considerations

Mergers are essentially capital transactions involving the change of ownership or the redeployment of assets in a manner dictated by market forces in which the acquiring corporation believes it can realize greater value for their shareholders. Most mergers are driven by the desire to acquire undervalued assets, to achieve economies of scale or to enter new product areas or markets. The present level of acquisition activity is also due to the improving economy and interest rates and continuing opportunities to enhance shareholder value. These are all economic considerations.

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[2] Reports were also issued by the Energy and Judiciary Committees.

Once a determination has been made to attempt to acquire another business, it can be accomplished in a variety of ways, and the tax consequences of each structure may differ significantly. The acquiring corporation may have either carryover or a stepped-up basis; the shareholders will either recognize their gain or defer the gain in a reorganization. Obviously, the tax considerations play a role in which structure is selected, but these considerations are subsidiary first and foremost to the inherent value of the acquisition and the business objectives of the acquirer, as well as the financial statement impact of the acquisition.

For example, according to the Wall Street Journal, the Chairmen of ABC and Capital Cities Communications considered but quickly discarded the sale of Capital Cities to ABC. Since Capital Cities executives would be in charge of the new company, they believed its shares would trade closer to the price/earnings multiple of Capital Cities. Because ABC was trading at a lower price/earnings multiple and had a larger number of shares outstanding, each additional dollar of earnings would translate into a larger increase in the per share price of Capital Cities than of ABC.[3]

The financial markets have reacted favorably to the transaction, with Capital Cities' stock rising in price as well as ABC. In fact, the transaction caused the market to favorably reevaluate the value of most companies engaged in broadcasting.

B. The Availability of Debt Financing Is Not The Determining Factor

Popular myths surround the use of debt in financing acquisitions. The most prominent myth is that management prefers debt financing because of the tax advantages of deducting interest and repaying principal versus the double taxation of dividends. The reality is that managements generally target debt/equity ratios for their overall company which takes into consideration their underlying businesses. If America's corporate managers looked primarily to the tax impact of corporate capital structures, they would not wait for acquisitions to increase their debt-equity ratios. Instead, they would maximize their leverage from the start.

However, the American capital marketplace has developed a bias against high debt-equity ratios. Investors and managers have an inherent belief that high levels of debt reflect weak corporate structure and financial risk. This perception can reduce the price investors will pay for the corporation's stock. Most corporations which incur large amounts of debt in the course of an acquisition attempt to quickly pare the debt in order to increase their equity ratio. Thus, despite the potential tax incentive to increase their ratio of debt in their capital structure, publicly held corporations generally decline to so act. For example, after Textron recently acquired Avco Corporation for $1.4 billion, Beverly F. Dolan, Textron's chief executive, announced his plans to sell $1.1 billion in assets over the next 12 months to reduce its debt to its traditional level, and then to buy more unrelated properties.4/

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[3] See "ABC Won't Yield Its Name in Merger With Smaller Firm", Wall Street Journal, March 22, 1985, P. 7.

In contrast, privately held corporations generally need not satisfy the market and concern themselves with their price/earnings ratio. This explains in part why leveraged buy outs (LBOs) generally involve higher ratios of debt in the corporate capital structure. Even in these situations, however, the sky is not the limit.

Over the last few months several announced LBOs have not proceeded because financing was not available; lending institutions declined to participate when the debt became too speculative. This indicates that the financial market can discipline itself; even in the case of highly leveraged LBOs, creditors clearly expect their loans to be repaid.

4/ Lueck, "Textron Still Has Takeover Fever," New York Times, January 27, 1985, Section 3, page 4.

C. Transactions Are Not Tax Driven

In the past, certain transactions were perceived by some as tax motivated. Perhaps the best example is U.S. Steel's acquisition of Marathon, in which U.S. Steel acquired Marathon in order to reduce its dependence on a mature, declining product line.

Whether or not the Marathon acquisition should be regarded as a tax motivated transaction, and I believe it should not, that method was eliminated by TEFRA in 1982. Yet, bids and acquisitions continue for oil and gas companies. The 1984 tax reform act restricted certain other tax benefits which were available. Despite the virtual elimination of tax opportunities and incentives through the passage of the 1982 and 1984 tax reform acts, merger and acquisition activity is continuing. Moreover, in most large acquisitions involving stock purchases, the acquiring company does not elect the potential tax benefit of treating the transaction as an asset acquisition. This demonstrates further that this merger activity is not tax motivated; as long as some investors perceive assets to be undervalued and to provide significant opportunities to enhance their value for their own shareholders, these mergers will occur.

D. Credit Markets Do Not Suffer

One mythical concern about mergers and acquisitions is that they crowd out more productive applications of bank financing. This concern is unfounded. Purchase prices in corporate takeovers simply represent the transfer of wealth from the stockholders of bidding companies to the stockholders of target companies, rather than the consumption of wealth. Funds borrowed to purchase shares are either reinvested, consumed or used to repay debts by the selling shareholders. To the extent the funds are reinvested, they replenish the capital available. To the extent the proceeds are consumed or used to repay debt, they are recycled into the credit stream in the same manner as other income. To the extent the proceeds are used to pay taxes arising from the transaction, such as the estimated $2 billion in capital gains taxes arising from Socal's acquisition of Gulf, the government may avoid additional deficit financing.

Moreover, the amount of borrowing used for even the largest corporate transactions is small compared to the size of the capital markets. This statement is supported by data in the statement submitted by Preston Martin, Vice Chairman of the Federal Reserve Board, last week to the House Ways and Means Committee's Subcommittees on Oversight and Select Revenue Measures.[5/] Vice Chairman Martin stated that while there might be very short-term effects on the availability of credit, the data indicated that merger activity does not create significant long-run changes in the credit and capital markets. At current high interest rates,

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[5/] This period covered by the data includes Texaco's acquisition of Getty Oil and Socal's purchase of Gulf Oil.

he testified, even the short term impact is small; the money is quickly recycled.

III. Current Regulation And Our Capital Markets

In attempting to deal with the question at hand, you should examine the tender offer process in the context of our nation's capital markets. The Williams Act governs the procedures involved in takeovers of publicly-held corporations. It was passed in 1968 to regulate tender offers. It is based on a Congressional determination that tender offers should be regulated primarily for the protection of investors to ensure full and fair disclosure, protect shareholders from fraud and manipulation, and provide for procedural fairness in the takeover process. The objective has been to let the market rather than regulation dictate the price and form of the acquisition transaction. Drafters of the Williams Act sought neither to encourage nor discourage takeover activity and took extreme care to avoid tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid. S. Rep. No. 550, 90th Cong., 1st Sess. (1967).

Under this system, our capital markets have grown over the last 50 years to become the best in the world with a depth and liquidity second to none. In fact, the size of the U.S. public debt and equity markets approaches $7 trillion, larger than the combined value of all remaining markets in the world. The size and liquidity of our capital markets is a critical element in the ability of corporate America to raise amounts of capital in a highly efficient manner.

Fundamental to the functioning of our securities markets is the pricing mechanism provided by the free access of buyers and sellers, each of whom has a view of values that is translated by the market into securities prices. Implicit in Congress' approach to market regulation is an obligation on the part of the shareholder to follow developments which affect the value of his investment.

The great weight of the evidence expressed before this Committee and generally during debate on anti-merger legislation in the Senate last year, as well as that presented both last year and earlier this year before the House Energy and Commerce Committee's Subcommittee on Telecommunications, Consumer Protection and Finance, and the House Ways and Means Committee's Subcommittee on Oversight, recognized that tender offers represent an efficient method for the allocation of managerial and capital resources within a free market economy and provide a mechanism for shareholders to realize value on their investment.

Viewed separately, both bidders and targets can make a seemingly appealing argument that they deserve concessions because the other side currently possesses a legislative advantage. While there may be discrete areas, such as greenmail, where action might be warranted, these emotional appeals to alter the securities, antitrust or tax laws should not be allowed to cause the distortion of an overall system of regulating tender offers that has worked well.

IV. The Takeover Process

A. The Evidence

Substantial evidence indicates that takeover contests are, in the aggregate, beneficial for shareholders and for the economy as a whole. Joseph R. Wright, Jr., Deputy Director of the Office of Management and Budget recently testified on behalf of the Administration that takeovers can perform several valuable functions, such as:

1. To allocate resources to higher valued uses;
2. To promote economies of scale and scope;
3. To increase investors' return from the stock of publicly traded companies, and thereby increasing the incentives to invest therein;
4. To reinforce market incentives that require management to compete effectively;
5. To free up captital for new investment opportunities; and
6. To move assets to smaller, more focused companies.

Wright concluded that takeovers often take place because a company's management has, over a long period, failed to deliver to stockholders the full value of assets owned by that company. "Sheltering publicly traded corporations from the discipline of the marketplace," he stated, "threatens the integrity of the marketplace."[6]

The Council of Economic Advisers' 1985 Economic Report to the President ("Economic Report") contained an extensive discussion of "The Market for Corporate Control". It concluded that "the current state of knowledge strongly indicates that further regulation of the takeover process . . . would be poor economic policy." It focused on three general areas in which takeovers generate aggregate net benefits to the economy:

(1) Production and distributional economies, including economies of scale and technology transfers;

(2) Shifting of assets to higher valued uses; and

(3) Improved management.

Extensive research has established that the benefits of takeovers to the economy as a whole exceed their costs. Successful takeovers substantially increase the wealth of stockholders in target companies. Although the magnitude of wealth increases vary, recent studies found premiums over the unaffected market price averaging 30% from tender offers, 20% from mergers and 8% from proxy contests.[7] In fact, the SEC's Chief

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6/ Statement of Joseph R. Wright, Jr., Deputy Director, Office of Management and Budget, before the Subcommittee on Telecommunications, Consumer Protection and Finance, of the Committee on Energy and Commerce. March 12, 1985.

7/ Jensen, "Takeovers: folklore and science," Harvard Business Review Nov.-Dec. 1984, P. 109 ("Jensen"); Jensen and Ruback, "The Market for Corporate Control - The Scientific Evidence, 11

FOOTNOTE CONTINUED

Economist, in a study of tender offers between 1981 and 1983, found that shareholders received premiums over market value of, on average 31.3% for partial offers, 55.1% for two-tiered offers, and 63.4% for any and all offers. 49 Fed. Reg. 26755, 26760 Table 4 (June 29, 1984).

The data indicates that the shareholders of the bidding companies also experience an increase in the value of their shares as a result of takeovers. This amount of the average price gain ranges from the 2.3% cited in The Economic Report to the 4% discussed by Jensen. Although this gain appears small, it indicates a significantly larger return on the assets acquired by the purchasing firm. Since the purchasing firm is usually much larger than the firm it purchases, the Economic Report interprets this 2.3% price gain as equivalent to a 9 to 11% average return on the assets of target firms to bidding stockholders.

Even corporations which successfully resist a tender offer often benefit from the experience. Martin Marietta's Chairman, Thomas Pownall, recently acknowledged that its takeover battles have resulted in its becoming stronger, faster growing and more profitable than it ever was. The Bendix situation forced Martin Marietta's management to restructure its assets and operations

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7/ FOOTNOTE CONTINUED

Journal of Financial Economics 5 (1983). The Economic Report cited studies indicating gains of 16 to 34%. These gains are exclusive of market price trends.

more quickly than it would have. The market price of its stock has since tripled.[8] Raymond Watson, the chairman of Walt Disney Productions at the time Saul Steinberg sought to acquire Disney, and William Douce, chairman of Phillips Petroleum, have also made public statements admitting that acquisition attempts on their companies have forced management to become more disciplined.[9]

B. The Liquidation Process

Acquiring corporations often repay part of their acquisition debt by liquidating assets. This process is not as frightening as its name suggests. The assets are not simply destroyed or abandoned; you do not pay a premium for worthless assets. Instead, what occurs is a divestiture of assets to new owners.

Generally, the liquidation of assets involves the orderly sale of businesses or major facilities of a company to another entity which will continue to operate it. Most of the employees of the business will generally continue in their same capacity, although layers of management may be discharged. Some of the divestitures occur in the form of LBOs involving the management of the divested business, thereby reunifying the ownership and the management of the company and creating additional incentives for the success of the business. If plants or offices are closed by the acquiror, it is to implement economic efficiencies. Even without the acquisition, many of these closings of facilities and divestitures of businesses would have eventually occurred; the acquisition might merely expedite the process.

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[8] See Chakranasty, "Thank You, Bill Agee," Forbes, March 11, 1985, page 44.

[9] See Bianco, "The Raiders; They Are Really Breaking the Vise of the Managing Class," Business Week, Mar. 4, 1985, at 82; Cuff, "Phillips Sees Benefits in Fight; Others Unsure", N.Y. Times, Mar. 6, 1985, page D.1.

Thus, divestitures of businesses need not be a traumatic event. The decision to sell assets is arguably harder on the management than the sale is on employees of the business. Large numbers of divestitures are occurring today unprodded by takeovers, but based instead on managements' decisions to redeploy their assets and refocus their efforts.

Finally, it should be noted that divestitures will occur whether the acquiror is hostile or friendly. New management, having paid a substantial amount of money to acquire a target corporation, will want to reshape its operations to recoup its investment. Many so-called white knights may divest more or even all of the businesses of the acquired company than the original bidder's announced plan.

C. The Planning Process

Some critics complain that takeovers reduce long-term investment planning by corporations due to the market's concern with short-term earnings. This argument is supported by no credible evidence and is logically inconsistent. If a company continually avoids long-term investment, it will eventually lose its ability to compete.

The equity markets value growth potential as well as current earnings. This is evidenced by the widely varying price/earnings ratios at which different stocks sell. For example, the market has long valued growth stocks at a premium, notwithstanding their low short-term cash flow and earnings. This pattern has continued in recent years as new issues of start-up companies, and in particular the new "high tech" companies, with little or no record of current earnings are sold at substantial prices and price/earnings ratios approaching infinity. These high price/earnings ratios make hostile takeovers extremely unlikely.

In a recent study, the SEC discovered no evidence in support of the thesis that increased ownership of corporate equity by institutional funds, combined with the short-term horizons of the fund managers, is facilitating hostile takeovers and prompting corporate managers to pursue short-term rather than long-term projects. During the period 1980-83, as institutional ownership of 324 surveyed companies increased from 30 to 38 percent, their ratio of research and development expenditures to sales increased from 3.38 percent in 1980 to 4.03 percent in 1983. That same study further found that the higher the institutional holdings, the higher the R&D to sales ratio.10/

Quite simply, only bad management will focus almost exclusively on short-term plans. Managements that allocate capital to higher valued uses, operate efficiently and adopt capitalization structures responsive to prevailing financial markets are far less likely to be subject to takeovers than other groups.

10/ Memorandum from Kenneth Lehn (Office of the Chief Economist of the SEC) to Chairman Shad, January 22, 1985.

V. Tax Policy and Legislative Proposals

A. The Tax System Should Be Neutral

The Treasury Department's Report to the President on Tax Reform issued last November stated that its primary goal was economic neutrality. It recognized that:

> One of the primary advantages of a free market economy is its tendency to allocate economic resources to their most productive uses. An ideal tax system would interfere with private decisions as little as possible. That is, it would not unnecessarily distort choices about how income is earned and how it is spent. It would not needlessly cause business firms to modify their decisions on how to finance their activities. A neutral tax policy would not induce businesses to acquire other firms or to be acquired by them merely for tax considerations. It would not discourage risk-taking or the formation of new businesses. In short, an ideal tax system would be as neutral as possible towards private decisions. Any deviation from this principle represents implicit endorsement of governmental intervention in the economy -- an insidious form of industrial policy based on the belief that those responsible for tax policy can judge better than the marketplace what consumers want, how goods and services should be produced, and how business should be organized and financed. [Deletions omitted.]

Our present tax system, despite its faults, neither enhances nor inhibits acquisitions; instead it has allowed the market rather than government to control the decision-making process. Our goal is similar to Treasury's goal -- a level playing field in which the tax consequences should not influence, but instead will follow, the business considerations. Any legislation which you consider in the context of mergers and acquisitions must be measured against this standard.

B. Tax Law is Inappropriate Medium

The tax law is an inappropriate medium for dealing with acquisition policies for several reasons. If changes are needed in the balance drawn for acquisitions, they should be enacted directly under the securities laws rather than indirectly through changes in the tax law. This will avoid disrupting the delicate regulatory balance under the securities laws, inconsistencies in the tax law and unintended consequences.

While I am not a tax expert, both the Treasury and the tax experts in the private sector who testified before the House Ways and Means Subcommittee on Oversight earlier this month were unanimous in declaring their opposition to special tax legislation to thwart mergers and acquisitions. The written statement of Assistant Secretary (Tax Policy) Ronald Pearlman concluded, "We do not believe, however that Congress should amend the tax laws for the purpose of generally discouraging merger and acquisition transactions." The Treasury Department and the tax bar have been unable to digest the major tax acts of 1980, 1981, 1982 and 1984, along with technical corrections recently introduced.

If you insist on changing the tax laws, we plead with you to do so in a rational manner which is consistent with the goals of a neutral tax system, rather than attempting to hit moving targets in the heat of a takeover battle. General tax reform proposals are currently being considered by Congress and the Administration. Moreover, the Senate Finance Committee staff is currently preparing a new draft of its proposals to revamp the corporate tax. These are the appropriate vehicles by which to amend the tax law.

C. Specific Proposals

Current legislative proposals, such as S. 420 and S. 632 attempt to block tender offers and protect current management by disallowing interest deductions and treating stock purchases as asset acquisitions if the acquisition is "hostile." Such proposals constitute bad tax and economic policy and will have unintended consequences.

1. Disallowing Interest Deductions

Both S. 420 and S. 632 propose to deny the deductibility of interest on debt incurred to acquire another company in a "hostile" transaction. S. 476 proposes to deny the deductibility of interest on certain "junior obligations" (junk bonds) issued in hostile takeovers. Contrary to the claims of its proponents, the interest deduction is not a "tax subsidy" favoring mergers.

Our tax laws have always permitted the deductibility of interest for funds borrowed for business or investment, whether used to purchase stock or real assets, or for general operating purposes. No distinction is drawn on the deductibility of interest between funds borrowed from banks and other institutional lenders, debentures issued on the market or seller financing, so long as it represents bona fide debt. We should not view the acquisition of another company through merger as any different than we would the acquisition of other assets used in its business. The resultant entity's income would not be properly measured if the interest deduction were denied.

There is no justifiable reason to discriminate against mergers as opposed to other types of capital transactions. Denying the interest deduction would also prevent the most efficient allocation of capital in our economy. Income tax law should not attempt to dictate credit allocation in the free market, thereby causing the removal of the highest bidders in a targeted industry from the market. The markets are sufficiently disciplined to prevent corporations from being too thinly capitalized. As is discussed above, a number of announced leveraged buyouts have not materialized because financing was unavailable on the proposed terms.

The first consequence of disallowing interest deductions in hostile takeovers is to reduce the prices that bidders will offer to shareholders of targets. By reducing the net cash flow available after an acquisition, you reduce the value to bidders. However, in many cases, the amount which can be offered will still constitute a premium to shareholders (albeit a smaller premium than if the deduction were permitted), and the acquisition will proceed. Thus, disallowing the interest deduction will merely reduce values to shareholders.

Second, disallowing the interest deduction will merely shift the types of bidders and targets; only the smaller bidders will be forced out of the market. A General Motors, IBM or Exxon has sufficient resources to acquire another company, while smaller companies which might have bid more will be unable to do so. Similarly, only smaller companies will generally be targets. Management of larger companies, no matter how poorly it functions will be much more difficult to replace or be stimulated to improve results if they are free from competitive bids. Again, investors will be harmed as values are not maximized.

Moreover, disallowing the interest deduction may unintentionally favor foreign investors over domestic ones, if foreign investors can deduct their interest expense in determining their foreign income. Since reducing the eligible pool of bidders reduces market prices, such a tax proposal could make it less expensive for foreign persons and corporations to acquire domestic corporations.

Disallowing the interest deduction may also have the unintended consequence of stimulating acquiring corporations to liquidate assets of the target in order to repay the debt incurred in the acquisition. To the extent this divestiture process is perceived as disruptive to the employees of the target company and the communities in which they operate, disallowing the interest deduction might increase rather than mollify this concern.

In addition, if you attempt to limit interest deductions only on acquisition debt, problems will arise in defining such interest. Money is fungible and any definition will be both overinclusive and underinclusive; attempts to distinguish between funds generated by cash flow from operations, general indebtedness and acquisition indebtedness will inevitably fail.

Finally, acquisitions will be restructured. If the interest deduction is limited, prices offered in cash tender offers (and therefore premiums received by investors) will be reduced. In addition, more stock for stock transactions would probably occur.

2. Hostile Versus Friendly Distinctions

S. 420, S. 476 and S. 632 condition the tax consequences of an acquisition on whether the target company consents to the acquisition. This distinction is pure nonsense. First, the difference between a friendly and hostile acquisition is usually a couple dollars per share; similarly, the difference between the raider and the white knight is usually who made the first bid and who made the final bid. Most consummated acquisitions which began as hostile deals ultimately take place with the approval of the board of the acquired corporation.

Second, once the acquisition is consummated, there is no economic difference between a friendly or hostile acquisition. If any adverse impact on an acquired company arises from a transaction, it will occur whether or not the acquired corporation's board ultimately approves the acquisition.

It is possible that conditioning the tax consequences of the acquisition on whether the target's board ultimately approves may prevent some tender offers from occurring because of the risk in consummating an acquisition if you do not know how the transaction will be taxed. An equally likely result, however, is that the bidder will offer a smaller premium, a result harmful to investors. Alternatively, the "hostile" bidder could offer say $50 per share if the target's board approves, and $40 per share if it does not, thereby placing additional power in the bidder and pressure on the target's board to consent to an uninvited bid.

Finally, conditioning the tax consequences of an acquisition on the blessing of the board of the acquired corporation would be bad tax policy. It is contrary to Treasury's desires to have the tax code be neutral and to subject taxpayers with exactly the same income and expenses to the same tax. Their tax should not hinge on the decision of the representative of the owners of the corporation, especially when these owners have consented to the acquisition.

VI. Greenmail

While there may be some merit to prohibiting or restricting greenmail payments, we strongly oppose the so-called "greenmail" provisions in some of the tax bills which have been introduced. I believe that if Congress determines that greenmail should be restricted or prohibited, the better way to achieve this result is to amend the securities law directly rather than through the indirect means afforded by the tax code.

S. 632 would disallow the deduction of greenmail. While we believe that present law probably disallows the deduction of greenmail by a corporation, we would endorse any such legislation which clarifies present law to prohibit the deduction.

VII. Conclusion

In conclusion, taxes are not the driving force behind the mergers and acquisitions occurring today. These mergers are driven by economic forces and their structure largely turns on operational and financial statement considerations. If your concern is to regulate practices in mergers and tender offers, the tax law is not the proper area of your focus.

STATEMENT OF PROF. JAMES S. EUSTICE, PROFESSOR, NEW YORK UNIVERSITY LAW SCHOOL, NEW YORK, NY

Professor EUSTICE. Thank you, Mr. Chairman.

My name is James Eustice. I am a professor at New York University, and for the past 20 years I've spent most of my time concentrating in the subject of corporate taxation. Merely appearing on this particular panel does not, I trust, evoke the common-position rule of the committee with my copanelists.

I come before you today to speak about tax policy, of which I have heard a great deal this morning. I have frequently found that those who feel that the current tax system is working well are themselves doing very well under that system. This reminds me of some choice comments on tax policy made by the late Lou Eisenstein in his book, "The Ideologies of Taxation," where he said that:

> Tax legislation commonly derives from private pressures exerted for selfish ends, and various groups are firmly persuaded that their functions are peculiarly vital to the progress of civilization. And so they easily reason that, since their contributions are exceptional, their taxes should be small.

He summed up these thoughts by stating that, "While ideologies invoke lofty abstractions, they are sensitively adapted to practical needs."

Now, what does this all mean in the present context? I think what it all means is that we need a new definition of junk bonds. These are obviously not junk bonds. In fact, they are so attractive, I would like to buy one myself, because they look a lot like equity. And I think that is the basic problem that is floating around in this room today, the attempt to draw the line between debt and equity.

As Secretary Pearlman noted an hour or so ago, the Treasury has abandoned its attempt to define that line. They tried, in the 1969 act, and failed, for a variety of reasons that I will not go into here.

That doesn't necessarily mean, however, that everybody should give up everywhere. True, I think a broad solution to the debt-equity line is vastly preferable; but what seems to me to be going on now is a virtual absorption, not only of the corporate equity in America but of the corporate tax base as well, in a form of de facto integration. The Treasury may be proposing partial integration, but what is going on now is that these high-yield multibillion-dollar issues are essentially coming close to eliminating the corporate tax base.

I think there were two other significant points that I am sure emerged inadvertently this morning from Mr. Pickens. One of his major buyers of these obligations is not your normal high-rate taxpayer but the IBM pension fund, and I am sure that if you look around at Sir James Goldsmith's backers you will find invariably that they are no-tax foreigners—either by virtue of a treaty or by virtue of the 1984 legislation abolishing taxation on interest income. In other words, we have here quite a striking rate arbitrage—to coin some investment banker language—or mismatch, if you will, of 46 percent deductions against zero-rate inclusion. In effect, corporate America is on the verge of turning into a giant tax-exempt bond fund.

All of which leads me to the conclusion: Are the tax laws the engine that are driving these transactions? Clearly not; nobody is asserting that. But I certainly think they are the steering wheel that is guiding the form of a lot of these transactions. I don't see multibillion-dollar stock offerings; I see multibillion-dollar quasi debt-equity offerings, and that is what I think is extremely troublesome here.

Thank you.

[Professor Eustice's written testimony follows:]

SUMMARY OF STATEMENT BY JAMES S. EUSTICE
BEFORE THE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT OF THE SENATE FINANCE COMMITTEE

APRIL 22, 1985

One of the traditional roles of Congress is to design a tax system whose impact on the economy and its taxpayers is consistent with the nation's economic goals.

A fundamental distinction in our two-tier tax system is the line between debt and equity. Broad objective standards for drawing the debt-equity distinction have thus far eluded the Treasury. In the absence of broad standards, Congress can and should identify and correct specific debt-equity abuses. S. 476 is designed to do that.

Section 279 of the Internal Revenue Code, which denies a deduction for interest on certain types of corporate acquisition debt, is an example of congressional action in this area. Section 279 was designed to prevent an artificial inducement to mergers. Similarly S. 476 is designed to prevent the tax law from providing an inducement to acquisitions that might not occur on the basis of their economic merits.

Although the abuse at which S. 476 is directed might well be corrected in fundamental tax reform, in this case one might question whether the economy and its taxpayers can afford to wait for such reform.

STATEMENT OF JAMES S. EUSTICE
BEFORE THE SUBCOMMITTEE ON TAXATION
AND DEBT MANAGEMENT OF THE
SENATE FINANCE COMMITTEE
April 22, 1985

Messrs. Chairman and Members of the Subcommittee: My name is James S. Eustice. I am a professor of law at the New York University School of Law, where I teach various subjects in the field of Federal Taxation, specializing in corporate taxation. I have also written books and articles in the field of Federal Income Taxation. I am also counsel to the New York City law firm of Kronish, Lieb, Shainswit, Weiner & Hellman. Kronish, Lieb has provided legal services to a variety of participants in the takeover process, among them Phillips Petroleum Company. Over the past twenty or so years, I have on various occasions informally advised the staffs of the Ways and Means Committee and the Senate Finance Committee, and also the Office of the Tax Legislative Counsel, primarily in the area of corporate taxation.

The Committee today focuses on certain selected aspects of corporate combinations and corporate acquisitions. In connection with that focus, I believe you have been subjected to a number of claims about what is good tax policy and what is not. It has always seemed to me that most of these claims about tax policy were made by people who had a specific objective in mind and that there is no "good tax policy" in the abstract. I have always suspected that those who claim that the current tax regime is "working well" are generally doing well themselves under that system.

Some of the most succinct statements ever made in this context were made by a distinguished Washington lawyer, the late Louis Eisenstein. In his book "The Ideologies of Taxation," he said, "Tax legislation commonly derives from private pressures exerted for selfish ends." He went on to say that, "Various groups are firmly persuaded that their functions are peculiarly vital to the progress of civilization. And so they easily reason that since their contributions are exceptional, their taxes should be small." He summed up these thoughts by stating that, "While ideologies invoke lofty abstractions, they are sensitively adapted to practical needs."

My own belief is that since the adoption of the 16th Amendment, there has rarely been "good" or "bad" tax policy in the abstract. The Congress is repeatedly called upon to make judgments about what impact the tax law should have on the economy of this country and its taxpayers -- corporate and individual. For example, when Congress felt that more low income housing should be built, it provided for certain rapid depreciation methods to apply to that type of housing. When Congress wished to encourage plant modernization, it provided for an investment credit and later ACRS. When Congress wished to encourage natural resource exploration, it provided for an intangibles deduction. It is certainly fair to state that many of our current tax provisions reflect consciously adopted policy judgments by the Congress as to what activities the tax law should encourage or discourage. This has been the case since the very beginning of our tax law and I have little doubt that it will continue to be so for the foreseeable future.

You have been asked to consider S. 476, which, in part, limits interest deductions on certain types of indebtedness, referred to as "Hostile Acquisition Indebtedness." One of the areas where Congress and tax experts alike have struggled mightily is where to draw a line between debt and equity. The Bill under consideration is but another chapter in that struggle. In our tax system, interest paid on debt is deductible and can save a corporation tax dollars, whereas dividends paid on equity are not deductible. If the federal tax system for corporations were fully integrated with the tax regime for shareholders, the distinction between debt and equity might not have such importance, but in our two-tier system, the distinction has enormous significance. The importance of this distinction becomes real when debt replaces equity as the basic brick and mortar of corporate ownership. When that happens, the deductibility of interest means that roughly half of the economic burden of financing corporate ownership is shifted to the United States Treasury.

In 1969, when you enacted section 385, you asked the Treasury to draw the line between corporate debt and equity. It has failed to do so, not because it has not tried, but because the line is an exceedingly difficult one to draw. In the absence of the broader guidelines that the section 385 regulations might have provided, S. 476 seeks to identify a very narrow area where a line should be drawn between debt and equity. Drawing such a line is neither "good" nor "bad" tax policy but is a legitimate response to a particular abuse situation that concerns this country and its business enterprises.

Broader debt-equity guidelines may well be desirable, but we do not have them. Their absence should not prevent Congress from identifying narrow areas of abuse and correcting them. Congress has addressed and corrected specific tax abuses in the debt-equity area before. Although a comprehensive rule might be preferred, a limited rule should not be rejected simply because it may be argued by some that the Treasury should be given more time to issue regulations. Sixteen years has already passed and we do not have those regulations.

Some will argue that narrowly targeted reform is unwise and should await the passage of broad and thoughtful reform of the corporate tax system. I myself am generally able to subscribe to that view. Like many of those here present, I have labored valiantly under the weight and velocity of recent tax law changes. But I question whether it is necessary that we must suspend all attempts to curb specific and egregious abuses of the existing law in order to await the promised land of "fundamental tax reform." We may wait forever, and find that in the interim all the chickens (and the eggs as well) are gone once we finally put a solid door on the hen house.

In 1969, your Committee acted on a type of measure similar to that which we now have before us. In response to the Treasury's request for measures that "will attack some of the basic tax problems involved in combinations and decrease the impetus toward creation of unusual security interests that are difficult for investors to evaluate," your Committee, in what became section 279 of the Code, limited the deduction for interest on certain debt securities which your Committee stated provided "a special and unwarranted inducement to mergers." In that section, your Committee disallowed the interest deduction on subordinated convertible debt issued in certain corporate acquisitions. Like section 279, the present bill is not designed to limit economic activity so much as it is designed to eliminate artificial tax inducements for merger. Other similarly inspired legislative responses in the 1969 Act included amendments to the OID rules of section 1232, tightening the installment sale rules of section 453 and modifying the stock dividend rules of section 305.

Section 279 imposed limitations on the ability of an acquiring company to issue subordinated convertible bonds that permitted the acquirer to pay for the acquisition through interest deductions. Today, the American economy faces a new type of acquisition activity -- acquisitions in which vast amounts of what are commonly called "junk" bonds (that is, high-coupon, subordinated bonds which are inadequately secured by conventional standards) are issued by a group of investors (or "corporate raiders," if you will) in order to obtain control of a business enterprise. In such an acquisition, conventional equity ownership virtually disappears -- to be replaced by putatively deductible-interest obligations.

The purpose of S. 476, like that of the 1969 provision, is not merely to take away an interest deduction; the purpose is to deny an interest deduction for an instrument when the Congress has determined that the investment behind the instrument should be treated as an equity equivalent, not debt. This was the policy that Congress adopted in 1969 for certain types of convertible debt. Those policy considerations are equally applicable today to the "junk" bonds that are the subject of the present bill before you.

It has been argued by some that permitting an interest deduction for highly leveraged debt instruments is not necessarily bad tax policy, since the lender will be taxed on that interest. My own limited experience is that "lenders" in these transactions are often either low rate or zero rate taxpayers. As you know, under many circumstances, foreign lenders, particularly since the 1984 Act, pay no tax on the receipt of interest income. You also know that banks and insurance companies often have very low effective rates because of certain provisions placed in the Internal Revenue Code which were designed to cushion them against financial adversity. These lenders rarely pay taxes at a rate which is as high as the rate paid by the industrial company that is the target in the transaction.

S. 476 obviously is not without its problems. Some have questioned whether it is good tax policy to permit the term "hostile acquisition" to be dependent upon the actions of certain members of the Board of Directors of a corporation. There are, of course, other methods for defining a hostile acquisition. One would be to expand the proposed provision by defining such an acquisition in great detail. My own view is that that would be a futile exercise. Another method would be to permit a different governmental agency to make that decision - such as the SEC. Although there is some precedent for permitting other governmental agencies to make decisions which affect taxes, those precedents have not been very satisfactory. Another option might be to permit a court, through the device of a declaratory judgment, to make the decision, but I believe our courts are already overburdened. In short, permitting the circumstances of the transaction itself to control the application of the statute appears preferable to the alternatives suggested.

We do not here face a new problem; we face continuing abuses in an area which has long concerned the tax policymakers of this country, the distinction between debt and equity in corporate ownership. When corporate raiders are able to abuse the lack of clarity in the distinction between debt and equity, then the Congress has every right to delineate adequate boundaries to prevent such abuse.

I have considered with interest comments by various persons who have spoken against tax legislation that is specifically targeted at the abuses of greenmail. A plea for inaction must be weighed against the possibility that something serious may be going on in the land and it may be necessary to move quickly to stem seriously abusive manipulations of the tax law. "Inaction" as we all know, is merely one form of "action". If it is determined by this Committee to be the case, then immediate action (or even reaction if you will) may be called for and the promised land of fundamental corporate reform will simply have to wait its turn in line -- it has waited for 70 years, and a few more can't hurt. In short, we live in a second best world in the tax law, maybe even a third best, depending on your point of view. It may be better to light a candle now (even a flickering and faint one at best) than curse the darkness and await the glorious sunrise. These proposals before you are not perfect, but the adoption of some of them may serve to even out some of the nastier lumps in what seems to me to be a very uneven playing field at the moment.

Senator Chafee. Gentlemen, I have got a problem—I am just terribly late. I have a couple of questions here, and I am going to have Ms. Porter ask you these questions so I can get them on the record. I absolutely have to go for a meeting the majority leaders has called.

Again, I want to express my appreciation for each of you coming, and I will read the answers. These are some questions which we have worked on in the past.

So, Ms. Porter, why don't you go ahead. If you will be good enough to stay for a few minutes, we will appreciate it.

Thank you.

Ms. Porter. Thank you.

Mr. Eustice, before I start the questions, had you finished your statement?

Professor Eustice. Yes, I was through.

Ms. Porter. Then I will take the witnesses in the order they spoke.

Mr. Andersen, you indicate that the buyers of junk bonds are smart institutional buyers, sophisticated enough to assess the risks they are assuming. Is that correct?

Mr. Andersen. I believe that the institutional market dominates the debt market to the extent of 99 percent of all debt, and that is true in high-yield bonds, high-grade bonds, or what have you. And basically these are people who have entrusted their funds to managers as portfolio managers, and I guess the presumption is that they must be intelligent enough to run the money.

Ms. Porter. If this is so, how do you explain the rash of problems that have developed in the relatively staid world of Government securities, specifically the Ohio S&L situation? Since only a few junk bond takeovers have actually occurred, how can you be so sure that there won't be similar failures in the future?

Mr. Andersen. I don't believe that there was any connection whatsoever between what happened in Ohio and junk bonds. I think that what happened in Ohio probably was the result of people turning their brains off and not thinking about what they were buying because of the presumption that they were dealing in government securities. I don't think the people who do their analysis and think about what they are buying, which you would do automatically if you were buying something labeled a junk bond, approach junk bonds with the same attitude that they do when buying Government securities which are labeled by everyone as risk free.

The fact of the matter is that when you remove intelligence from any decisionmaking process, you increase risk. And the Ohio companies certainly did.

Ms. Porter. The study by Robert Altman that you have mentioned shows that in the last 10 years most of the bond defaults that have occurred are junk bond defaults. Doesn't this imply that junk bonds are infinitely more risky than investment grade bonds? I believe the study shows the default rate on junk bonds was 1.6 percent a year, compared with a 0.08-percent default rate for all corporate bonds.

Mr. Andersen. I think if you look at the Altman study you will find that he also includes in his defaults and in his default rates all of the bonds that were originally issued as investment-grade bonds and subsequently downgraded. I think that you have to differentiate again between those bonds that were purchased by people looking at them and doing their analysis of high-yielding bonds and those bonds which were purchased by people who relied upon the rating agencies and turned their brains off and bought them thinking they were high-grade bonds.

I think you will also find that the Altman study concludes that, despite this higher rate of defaults, even with his numbers, which I dispute bitterly, that the default rate was almost four times overcompensated for by the rate of return.

So therefore, the fundamental premise on which the whole high-yield bond market rests, which is portfolio diversification, is alive and working very, very well, according to Mr. Altman.

Ms. **Porter**. One last question for you, Mr. Andersen.

On March 1, Sharon Steel Corp. failed to make interest payments on about $426 million in triple-C rated debentures. This may be the largest junk bond default ever. Doesn't this cause you some concern, and shouldn't we be worried about the possibility of an economic downturn? With about $100 billion of outstanding low-rated high-yield bonds, isn't there a real danger of a fallout next time we have a recession?

Mr. **Andersen**. I would like to make two points. One, the Sharon Steel bonds were not underwritten, and they were not offered by an investment banker. They were done in an exchange offer, negotiated at arms length between two companies that were not in a hostile takeover situation. They decided that one of the appropriate ways to pay for it was to trade the paper. I am not sure that they were rated at the time they were issued, OK? No. 1.

No. 2, when you look at the high-yield bond market, what you have to understand is, if 85 percent of all of the companies out there would be rated less than investment grade, those companies aren't financing for the first time. What you have is all of those companies that were in the banks have now found a way to securitize loans the same way that the thrifts have found a way to try and relieve the pressure on their institutions by finding it in the marketplace. And when you make the decision that you are going to worry about that, I think what you really should worry about is the biggest junk bond of all which was the Continental Illinois bank depositor. He held junk paper, and you bailed him out.

What I am trying to do is to help those institutions. I am trying to relieve the pressure by finding a better, more efficient way to take those credits in the marketplace where hundreds of people can examine them, as opposed to some lending officer who has a cozy deal with somebody from Penn Square who is taking their paper.

Ms. **Porter**. Thank you, Mr. Andersen.

Mr. Maher, do you have any comments that you would like to make before I ask you the one question that the Senator left for you? Do you have anything you would like to add to Mr. Andersen's comments on some of the questions I asked him, since you are similarly situated?

Mr. **Maher**. No.

Ms. **Porter**. All right. You seem to have stated in your testimony that the benefits of takeovers far exceed the cost, echoing the administration's position that further regulation of the takeover process would be bad economic policy. Do you believe, then, that large corporations should simply be torn apart without regard for employees, communities, or customers, solely in order to pay off speculative debt?

Mr. **Maher**. Well, I think I would make a number of points in regard to your question.

First, it is difficult to distinguish between divestitures by a large corporation to repay acquisition debt from divestitures in the ordinary course of its business. Every day, in the normal practice of our business we see companies selling divisions. Based on my experience, I don't think that such a divestiture really is a wrenching experience for the division employees. Most of the employees generally retain their positions under new management. It is simply a part of the ordinary course of American business.

In terms of relocation of headquarters, and so forth, I think that is also a process that continues in the United States on a daily basis. For example, over the last few years when a number of corporations have moved their headquarters out of New York, it always caused a great upheaval. As I recall, however, Congress took no action to keep American Airlines or Union Carbide in New York.

Ms. **Porter**. Felix Rohatyn in the Wall Street Journal last week stated that there is a growing feeling that the capital markets have become the property of insiders and speculators, of raiders and professionals, to the detriment of the public. He also said that the public confidence in the integrity of our securities markets and our financial institutions is eroding. Do you share any of those views at all?

Mr. **Maher**. Well, if I remember, I think it was an editorial in the Wall Street Journal. He touched on a number of disparate things ranging from the Government securities to takeovers, and so on, and so I think it is awfully hard to lump them together.

I am sure that the problems with Government securities traders and the resulting problems with savings and loans have caused some problems with investors' confidence. However, I am not so sure that I would put takeovers in the same category.

Ms. **Porter**. And finally, we were talking to Mr. Andersen about the problems with junk bonds if there is a slowdown in the economy. Do you have any concerns about the future of these junk bonds if there is a slowdown in the economy?

Mr. **Maher**. Well, I think there is an interesting question in terms of highly-leveraged companies. But I think both if you look at junk bond corporate takeovers and also at the same time look at leveraged buyouts, the investors in those situations have, in my experience, taken a very careful look at the risks associated with those companies in which they were investing.

Ms. **Porter**. Mr. Eustice, I have just two questions for you, one with regard to your ideas for improving the distinctions between debt and equity, since you think this is the problem in the junk bond area. Do you have any ideas you would like to put forth for a proper distinction?

Professor Eustice. Well, as I mentioned, the Treasury put an enormous effort into this in their regulations. There were at least three versions which changed somewhat, and I think even substantially, over the process. That, of course, was an attempt to be universal.

And the other approach, and the one I believe Senator Chafee and Senator Boren's bill, for that matter, target in on a more limited definition. There actually is precedent for that that goes back into the 1969 act; as a matter of fact the same act that gave the Treasury the power to do something broadly, said, "We'll do this narrowly."

Secretary Pearlman said this provision, to his knowledge, has never applied, and it has not to my knowledge either, because people don't do things to qualify for that section.

Ms. Porter. You are referring to section 279?

Professor Eustice. To 279. And if you want to slow down a particular procedure, if Congress feels that this particular game is on nonstop fast-break, I think this may be one way to at least slow the action a little bit. A narrowly defined definition.

Now, how to define it? Well, I am not prepared in my limited time to do so. I think obviously you can improve a definition. There isn't a definition alive that couldn't be improved.

You have choices. I think you could go the route of an incredibly-detailed statutory definition. That has been the congressional norm of late, followed by a delegation to regulations which never happen. I personally would not like to see that happen again.

You could delegate the decision as to "hostility," or affection for that matter, to another agency such as the SEC, or you could allow a declaratory judgment procedure. All of those I think would be legitimate. I don't think that the independent director test is as bad as some others you could come up with.

On reflection, I think I could probably tinker with that definition somewhat, but it seems to me to be a reasonable definition. I do not feel that present independent directors are the malleable toadies that they have been suggested to be.

Ms. Porter. Do you think that any changes ought to be made in section 337?

Professor Eustice. Not yet, no. We are currently involved in a major broadscale project dealing with the interrelationship of 337 and 338, and a total restructuring of subchapter C.

The mandatory 338 election is not the problem here; it is the interaction of stepped-up basis and nonrecognition.

Ms. Porter. Do you see any problem in the ability of property and casualty companies to file consolidated returns with nonproperty and casualty insurers?

Professor Eustice. I have spent my entire career avoiding questions on the taxation of the insurance industry, and I am afraid I am not able to enlighten you on that.

Ms. Porter. Fine. Thank you.

The hearing will be adjourned.

Professor Eustice. Thank you.

[Whereupon, at 1:32 p.m., the hearing was concluded.]

[By direction of the chairman the following communications were made a part of the hearing record:]

Rec I

IBM International Business Machines Corporation

Office of the Assistant Treasurer
Corporate Headquarters

1200 High Ridge Road, P.O. Box 10178, Stamford, CT 06904

April 29, 1985

The Honorable John H. Chafee
Chairman, Subcommittee on Taxation
and Debt Management of the Senate
Finance Committee
U.S. Senate
Washington, DC 20510

Dear Mr. Chairman:

I would like this letter to become part of the official record of the subcommittee hearings on April 22, 1985 concerning hostile merger activity.

Two witnesses appearing before your committee on April 22, 1985 stated that a number of corporations, including specifically IBM and the IBM pension fund had purchased so called "junk bonds."

IBM denies that we have ever participated in the buying of "junk bonds." We have no money managers who are chartered to purchase "junk bonds" for us or our retirement plans. In addition, none of our funds contain any significant amount of "junk bonds."

IBM wishes to make this part of the record to clearly establish that IBM's portfolio holdings and IBM should not to be used to either credit or discredit positions on hostile take-overs or mergers.

Sincerely,

Bruce E. Langton
Assistant Treasurer

BEL/smk

EXCERPT FROM SPEECH GIVEN BY TALTON R. EMBRY OF MATBEN ASSET MANAGEME. CORP. BEFORE THE FINANCIAL ANALYSIS FEDERATION

Most of the time, the anxiety of high yield investing is overdone. Some of the time, the anxiety is not justified at all. Think about all of the high yield issuers with whom you deal everyday. Think about the enduring values of their businesses because of your personal patronage. Think about the managements who are working to improve the credit ratings of their companies—not working just to maintain a single, double, or triple A, but working to create a single, double or triple B credit—working to make you money.

We are all here in New York City. Ten years ago, the city was going bankrupt. A large building down the street from here adjudicated valueless. There was no future for the city of New York or its real estate. Credit upgrade.

The room in which you are sitting is heated, cooled and lit by Con Edison, a notoriously bad credit. Another company that was once near bankruptcy, another upgrade.

If you came here by subway or bus, the provider, New York State, is another high yield issuer whose credit has been highly suspect. If you came here by car, it might have been in a Chrysler, American Motors or Ford. The tires upon which the car rode were certainly from a high yield issuer, whether it was Armstrong, Firestone, Goodyear, Goodrich of Uniroyal. The fuel powering the car may be from Amerada Hess, Cities Service, Dome Petroleum or Phillips. Perhaps you parked it in a Kinney lot.

If you came here by train, you came in over the Penn Central/New Haven Line. If you came in from the Mid-west by rail you might have come on the Chicago Pacific, the Milwaukee Road, the Chicago Northwestern, the Illinois Central or the Western Pacific. Regardless of the line, you probably rode on ACF wheels and when you saw freight moving, it's a good bet that it was in CTI/GELCO or ITEL containers.

It is virtually impossible to take air transportation in the United States without flying high yield. American, Continental, Eastern, Muse Air, Pan Am, Peoples, Republic, TWA, United, US Air, Western or World are all high yield issuers. Don't forget that the monogram division of Nortek made the toilets on those aircraft.

Wherever you travel you will see billboards despoiling the view. These are by Ackerly, American Sign and Indicator and Metromedia. The ads might have been placed there by Mickelberry or John Blair.

While you are here working, you might be wearing clothes purchased at a high yield issuer, Carson Pirie Scott or Higbees or Montgomery Ward. Your BVD's are from Northwest Industries. Your suit from Palm Beach, Inc., your tie from the Bert Pulitzer's division of McGregor's or your shoes from the Johnston & Murphy division of Genesco.

While dining, you might eat high yield food. Olives from the Early California Industries, beef from Occidental, bananas from United Brands, pineapples from Castle & Cooke. The company actually doing the cooking may be a subsidiary of Allegheny Beverages, Trans World Corp., ARA Services, Collins Foods or Horn & Hardart.

In your room, you can watch channel 11 which is owned by RKO Gencorp., or channel 5 which is Metromedia or CNN News by Turner Broadcasting. The shows themselves may be produced by Cannon, Lorimar, MGM/UA, Orion, Paramount, Twentieth Century Fox or Warner Brothers. A good many of the stars are represented by Josephson International. These are all high yield issuers.

Since the reception is not too good, the set will be connected to cable. The cable box might be by Oak Industries. I don't know who the company is that provides cable in this building, but it might be Cable America, Cablevision Systems, Canadian Cable, Harte Hanks, Jones Intercable, Prime, Storer, or Telecommunications.

Some of you will step out tonight. You will slip on your After Six tuxedo, strap on a Piaget or Corum watch from North American Watch, stuff your Globe Theater ticket from International Banknote into your pocket and hail a Checker Cab for a night at the theatre. During the intermission, you can have Champale by Iroquois Brands, a shot of Schenleys or a Schlitz, Pabst or Swans.

The city can be a dangerous place, so you'll want to take insurance. You can buy this from American Financial, City Investing Home Group, one of American Can's financial subsidiaries, Mission Insurance, Freemont General, Reliance or Zenith, amongst others. Perhaps it is easier to call your insurance broker at Alexander & Alexander or Frank B. Hall.

Whatever you do, while you stay here in New York don't forget to call home over MCI or send a Western Union Telegram. Of course, you will want to pick up some gifts for the kids. Make it something from Coleco or Mattel.

Rec P

THE PROCTER & GAMBLE COMPANY

EXECUTIVE OFFICES P.O. BOX 599 CINCINNATI, OHIO 45201

May 6, 1985

The Honorable John H. Chafee
Chairman of the Subcommittee on Taxation and Debt Management
Room 221
Dirksen Senate Office Building
Washington, D.C. 20510

Dear Senator Chafee:

It has come to our attention that on April 22, Mr. T. Boone Pickens testified before your subcommittee on Taxation and Debt Managment. In his testimony, he made the following statement:

> "Some of the biggest buyers of junk bonds are the IBM Pension Fund, and Prudential Insurance Company, and Procter & Gamble pension funds. I mean, these people are looking at these situations very closely. They are not just going into deals shooting from the hip".

This statement is factually incorrect and does not reflect The Procter & Gamble Company's investment policy. Our policy for fixed income securities is to acquire bonds with a rating of A or better for our retirement plans, employee benefit plans and the investment of surplus funds of our parent company and its subsidiaries. This applies to both our outside fund managers as well as funds managed in-house. This policy thus precludes our investing in so-called "junk bonds". The policy has been in place for a number of years thus we do not hold junk bonds in any of the various investment portfolios of The Procter & Gamble Company or its subsidiaries.

This requests that this correction be made to the record of Mr. Pickens' testimony.

Thank you for attending to this matter.

Edwin H Eaton

Edwin H. Eaton
Treasurer

TESTIMONY

OF

JAMES B. EDWARDS

PRESIDENT, MEDICAL UNIVERSITY OF SOUTH CAROLINA

AND

MELVIN R. LAIRD

SENIOR COUNSELLOR FOR NATIONAL AND INTERNATIONAL AFFAIRS

FOR

READER'S DIGEST ASSOCIATION, INC.

BEFORE THE

COMMITTEE ON THE JUDICIARY

UNITED STATES SENATE

May 1, 1985

Thank you Mr. Chairman. It is a pleasure to be here this morning. I applaud the committee for scheduling this hearing to review the very significant public policy issues that exist today because of the recent increases in hostile corporate takeover attempts. Mr. Chairman, I am James B. Edwards, President of the Medical University of South Carolina and an independent outside director of 6 major corporations: One of these companies, Phillips Petroleum Company, has been the subject of two recent hostile corporate takeover attempts over the last four months. Today I am appearing as an independent board member. My statement also reflects the views of the Honorable Melvin R. Laird, a former member of Congress and Secretary of Defense, who is also an outside independent board member of 8 corporations and serves with me on the Phillips Board. Between the two of us, we have witnessed five hostile takeover attempts. Mr. Laird had hoped to be here with me today, but he agreed several months ago to appear at the University of Wisconsin with Secretary of Transportation, Elizabeth Dole. They are both appearing at a youth leadership conference and he was unable to break that commitment.

Over the last couple of months there has been a wealth of information provided to various committees of Congress concerning the pros and cons of corporate mergers, particularly hostile corporate takeovers. Before I go any further, Mr. Chairman, let me say that no one is a greater defender of the free enterprise system than I. I have spent my whole career in support of the American economy and the free market that has made it great. However, I believe that there are specific reasons why the federal government needs to be concerned about the problem of hostile corporate takeovers. The conclusions that I have reached are based upon my experiences directly with companies involved in the thick of a hostile corporate takeover, as well as my experiences in and out of public life including, as you know, Mr. Chairman, having the privilege of serving as Governor of the State of South Carolina and as Secretary of the U.S. Department of Energy. I have not arrived at my recommendations lightly for I believe that basically, federal intervention in the marketplace should be avoided. However, the events that are occurring in corporate America are producing serious negative side effects to our economy and our society. In a nutshell, Mr. Chairman, I believe the problem can be characterized in one phrase -- and that is: The emphasis upon short-term profit over long-term performance. When we look at hostile corporate takeovers in this light, we begin to understand the concern.

Mergers and acquisitions among companies who are seeking to expand into new markets, grow existing product lines, or diversify into new businesses are legitimate transactions of the free market. I support the ability for the marketplace to reallocate resources in this fashion, consistent with our society's goals of fair competition, shareholder equity, and the production of jobs and products for employees, communities, and customers. There is very little argument that I am aware of that provides credible support for government interference to further restrict routine business combinations that will foster these goals.

This is an important point, Mr. Chairman, because the corporate raider will tell you the same thing -- that mergers and acquisitions are in the shareholder's interest. Mergers often maximize shareholder return, create wealth, and even increase federal revenues. They will tell you that business mergers transfer assets into more productive uses and to more efficient managers. And this is generally all true, Mr. Chairman, when you're talking about soundly financed acquisitions that will redeploy the target company's assets for continued use. What the corporate raiders won't go to the trouble to tell you is that they aren't interested in the continued operation of the target company. They also won't make clear that their real objective is control of those assets for the main purpose of a quick sale and a quick profit that will leave the target -- which before the raid was a profitable, successful company -- completely liquidated or so burdened with debt that any attention to long-term performance is out of the question.

Now 15 or 20 years ago -- even 10 years ago -- there weren't these kinds of takeover attempts. When corporations sought out acquisitions -- they had to have a strong enough balance sheet to support a credible financing package for the target company. Lending institutions were conservative -- they didn't have a track record of loaning out huge sums of money without adequate security. If a lender was going to commit $100 million to an acquisition -- friendly or unfriendly -- he was first going to be sure that his client could cover the loan with his own assets. In other words, the acquiror was in the hunt because his judgment of the business gave him confidence that the target company's assets would be a strategic fit with his own business, offering value either in expansion or diversification. And he was prepared to risk a sufficient amount of his own equity on the move.

Otherwise he wouldn't be looking to buy, and lenders would not loan him the money to buy if he wasn't able to secure the loan. This situation, then, by its nature, produced acquisition attempts by strong companies to purchase weaker companies, and generally, larger companies seeking smaller companies.

Recently, the relatively new phenomenon of the highly leveraged hostile takeover attempt has emerged in the marketplace. I'm sure, Mr. Chairman, that you and the other committee members are familiar with the basic characteristics of this type of acquisition attempt. Innovative professionals in the financial industry, led by the Wall Street firm of Drexel Burnham Lambert, Inc., have developed a method of utilizing the low-grade, high-risk, high-yield debt market -- which has been around for a long time and has served as a valuable financial source for many firms -- as a tool for a corporate raider to prowl the marketplace, identify sound, profitable companies with under-valued assets, and make a move to acquire these assets without putting up the normal security once required. The catch is that, if the raider pulls off the deal -- and he uses provisions of the tax code and securities laws and regulations to his advantage to give him a leg up on management -- his prize will be so burdened by the high-risk debt -- known as junk bonds -- that he will liquidate the assets of the newly acquired company to pay off his creditors.

In effect, Mr. Chairman, to the corporate raider, the company is worth more dead than alive.

An article in the March 4, 1985, issue of Business Week, describes this process fairly well. It says, and I quote:

> "Drexel's 'leveraged' takeover works like this: The buyer sets up a new company on paper. Drexel creates a package of junk bonds to be issued by the paper company once it gains control through a tender offer. Then Milken (Drexel's head of its joint securities trading department) and his 125-person staff contact junk-bond investors, seeking advance commitments

to buy the bonds. Once in control, the raider can raise cash by selling off pieces of his new property. 'We take a minnow, identify a whale, then look to its assets to finance the transaction,' explains Michael D. Brown, Drexel's West Coast merger chief."

Thus, the minnow, having acquired the whale, cuts out its heart in order to finance the transactions. Notice that the targets today are strong companies with solid balance sheets -- not companies on the verge of bankruptcy. And their size is also no barrier to the raider.

Capital is thus no longer available for research and development or longer-term projects. The company's growth disappears; communities are de-stabilized and employees laid off; and suppliers and customers are disrupted. True, some shareholders may see short-term gain, but their long-term prospects for investment in the business are seriously diminished. As an independent outside Director, I believe that is not consistent with the interest of shareholders and the other constituents of a corporation to approve the liquidation of the business for what is, above all, a transfer of wealth from the equity base of the company to the corporate raider and his financial backers.

Mr. Martin Lipton, partner in the law firm of Wachtell, Lipton, Rosen & Katz, a leading authority on corporate takeovers and legal counsel to Phillips, recently made the following comment specifically about this practice that I believe clearly describes the problem:

> "These takeovers are not for the purpose of diversification, expansion or growth, but are financial transactions for the profit of the takeover entrepreneurs. They do not add to the national wealth. They merely rearrange ownership interests by substituting lenders for shareholders and shift risk from equity owners to creditors. They place our banking system and credit markets in jeopardy and restrict the ability of the affected businesses to grow and provide increased productivity and employment. They do not move assets into more efficient management. They move assets into hands that profit by reducing expenditures for research and development and capital improvements. After a highly-leveraged takeover, a very high percentage of the revenues produced by the acquired assets are diverted to paying the debt incurred to acquire the assets. One can compare this situation to a farmer who does not rotate his crops, does not periodically let his land lie fallow, does not fertilize his land and does not protect his land by planting cover and creating wind breaks. In the early years, he will maximize his return from the land. It is a

> very profitable short-term use. But inevitably it leads to a dust bowl and economic disaster. We have entered the era of the two-tier, front-end loaded, boot-strap, bust-up, junk bond takeover. Day after day, the takeover entrepreneurs are maximizing their returns at the expense of future generations that will not benefit from the research and development and capital investments that takeover entrepreneurs are forcing business to forego."

Why have we seen the emergence of this activity?

One reason is that the shares of companies that reinvest substantial portions of their earnings into research and development and long-term capital projects are valued in the marketplace below their true worth. The stock market discounts future profits because of the diversion of earnings into these areas.

I also believe, Mr. Chairman, that we are witnessing today an undervaluation of stock prices, in part, because of the inflationary environment of the last fifteen years. Until recently, high interest rates have allowed investors to cash out of equities and buy government securities, where they could receive a 15-16% return risk free. Equity ownership, therefore, was not as attractive. Management, in the meantime, continued to add value to their companies by reinvesting -- in capital and research and development. Asset values increased, while stock prices, proportionately, did not. Managements were in most cases doing the right thing to add value to their companies. Some managements may not have performed as effectively as possible and this too has been reflected in lower stock prices. But, Mr. Chairman, as I will describe shortly, the wave of hostile corporate takeover attempts is so far-reaching that I would not be surprised if only a handful of American companies are immune. I can't believe that the managements of all the other U.S. corporations have all been inefficient at enhancing shareholder value and hence totally responsible for the undervaluation of stock prices that is a necessity for the corporate raider to launch an attack. What we need to worry about, Mr. Chairman, is that today's managers will get the message that the hostile raiders are sending -- If you want to keep your company from being liquidated - emphasize the short-term gain and sacrifice future growth and profit.

Of course, I believe that it was then and is now essential for management to avoid this type of mentality and concentrate on thinking strategically -- thinking long-term -- if the shareholders' investment is to be maximized over the long term and if our businesses and our economy are to be able to innovate and produce the goods and services desired by customers. As an independent outside Board member, it has been my duty to encourage management to place the long-term interest of the business as a top priority. This is clearly the case in Phillips' recent corporate battles. As you know, Phillips is a large integrated petroleum company. The petroleum industry is a high-risk, capital-intensive, long-term business. A company's success depends upon exploration to find and replace the oil and gas reserves produced. As you know Mr. Chairman, a company drills many more unproductive wells than successful ones in the search for oil and gas. A company exploring for new reserves, therefore, must be sufficiently strong to absorb such losses without jeopardizing the shareholders' investments. If it fails to find commercial oil or gas reserves, sizeable economic losses may be sustained and national security is seriously jeopardized. We should never forget the days of the Arab embargos and the long lines at the gas pumps. On the other hand, if exploration succeeds, a discovery probably will require years of heavy cash investment before production begins. For these reasons, the industry must quite often fund new projects from the internal cash flow from current operations. This equity or cash flow funding is necessary to protect the long-term value of the shareholder's investments. Management cannot look solely to short-term gains if it is to meet its responsibilities to shareholders, as well as to the energy needs of our nation.

To underscore my point: Equity...or cash flow funding...is an important feature of an oil company's capital structure. Substantial amounts of equity are necessary if a company is going to be effective in the oil and gas business.

When I served as the Secretary of Energy, my objective was to encourage company managements to undertake aggressive exploration and production programs to find new energy reserves - build for the future so this country had a more secure energy foundation. Companies have responded, increasing capital budgets, and research, to find the energy required by all Americans. The only problem is that stock prices have not gone up and managements are in double jeopardy -- knowing that they must invest to find new reserves, but seeing this reflected in a higher value for their asset base, not their earnings.

This situation has been magnified recently because the market today prefers immediate return to the shareholders rather than steady growth as reflected in the future discounted earnings of the company. In my opinion, the market is more short-term oriented today than at practically any other time. The reasons for this are complex, Mr. Chairman, and I don't want to attempt to offer the committee a thorough treatise on its causes. However, I would like to point out three trends that bear heavily on this short-term orientation:

First, is the increasing presence of institutions as owners, or fiduciaries of owners, of America's corporations. Twenty years ago, more of the common stock of corporations was in the hands of the small shareholder. Today, institutions control some 60 percent of all the shares and carry out at least 75 percent of all the transactions occurring in the market. Private pension plans and the retirement systems of cities, states and public-employee groups now control assets worth in total close to $1 trillion. Estimates are numerous that the private and public pension plans own 35 percent of the equity capital of all U.S. corporations. And the managers of many of the largest U.S. companies don't need to be reminded that institutional ownership of companies they oversee often comprises 50 percent to 60 percent of the outstanding stock.

What does this mean? It means that ownership is no longer dispersed and takeovers are easier than before. Years ago, the difficulty of gathering stock from thousands of individual investors made hostile takeovers -- then called proxy fights -- a rarity. Today, with concentrated ownership, a raider can gain control of a company in a matter of days by offering a premium for the stock.

Why can a raider do this? Under the fiduciary relationship, institutional managers are obliged to seek the highest possible return on the funds entrusted to them, consistent with an appropriate level of risk and in accordance with the rules and instructions of the respective trust or pension plan. Trustees, including pension plan administrators operating under the requirements of the Employee Retirement Income Security Act of 1974 (or ERISA), carry out their responsibilities accoring to the "prudent man" rule. This means that the trustees must use the care, diligence and skill that would be exercised by a prudent man in the conduct of his own private affairs. The standard of measure for what constitutes "care, diligence and skill" has been applied with varying degrees of strictness to the trustee. It appears that when hostile takeover attempts occur institutions are implementing the prudent man rule by accepting any premium over the current stock market price rather than holding a portfolio investment for appreciation in the future. This investment policy is mandated by the competitive necessity for institutional investment managers to show better performance than the market as a whole and than other investment managers. New business flows to investment managers on the basis of their investment performance compared to each other and to the stock market as a whole. Thus, they have a strong incentive to focus on short-term portfolio performance rather than long-term investment. In fact, this leads investment managers to manipulate the price they could ultimately receive from their stock. This is done most effectively in concert with the raider. Takeover entrepreneurs have, thus, gained the active support of major institutional investors. This further exacerbates the bust-up takeover problem.

Second, the market is becoming more and more dominated by the professional investment bankers, brokers, lawyers, and arbitrageurs -- who profit from market transactions. These people stand to gain from stock run-ups caused by hostile takeovers, from deals made to keep corporate raiders away from the target company's assets or from the search for a "white knight" company to bail out a target from a hostile raid. A company's stock goes up when a raider takes an interest in it, because scores of other investors -- mainly institutional holders and arbitrageurs -- trust the raiders' instincts for a good thing and know that, where there's a raider, there's usually fired-up stock value. It's almost a self-fulfilling prophecy: A stock rises when a raider buys it in large part simply because the raider has bought it.

Third, as I referenced earlier, institutional lenders -- including some Savings and Loans and pension funds -- no longer are shying away from riskier investments. These institutions are joining the corporate raider's ranks because they see huge returns with little risk. Junk bonds, as you know, Mr. Chairman, are debt instruments rated below investment grade by the rating services. They carry interest premiums above the investment grade obligations to compensate for the added risk. These instruments have typically been shunned by the conservative investor because of the high risk associated with them -- hence the perjorative name of junk. However, if the raider can convince a Savings and Loan, for example, that he will, in effect, secure his junk debt with the assets or cash flow from the target company -- a company he does not even own -- then the Savings and Loan's investment has little risk. In addition, the raider will probably provide the institution with an up-front "commitment fee" to sweeten the deal. Should the raider fail, the Savings and Loan loses nothing, even keeping the commitment fee. That was just for giving the raider the right to the loan at a later date. Should he succeed, then the target will be asset-stripped or have cash flow diverted to service and retire the debt. And in the meantime, the high-interest premiums from the junk bonds provide a substantial return to the lender. The historical "stigma", if you will, that lenders have had against investing in the junk market no longer holds.

Nicholas F. Brady, whom you know as a former colleague and who is now Chairman of the investment banking firm of Dillon, Read & Company wrote an article appearing in last Thursday's (April 25, 1985) New York Times entitled: Equity is Lost in Junk-Bondage. His short piece on junk bonds provides good insight into the negative consequences of their use in hostile takeovers and supports the points I have just mentioned. He writes, in part:

> "Speculative, highly leveraged financing techniques involving junk takeover bonds, if unchecked, will leave misery in their wake. Junk bonds -- essentially high-risk, high-yield, less than investment-grade debt -- have long been around. What is new, and dangerous, is the rapidly expanding use of such securities to finance highly leveraged hostile

> acquisitions...These bonds entail substantial risks to investors -- risks that often have not been, and cannot be, adequately assessed...Why do many raiders, insurance companies, foreign banks, pension funds, savings-and-loan holding companies and a nationwide church join a junk takeover-bond syndicate? Because of substantial commitment fees, very high interests rates and the right to share in "greenmail" profits...What's worrisome is that junk take-over financing -- which is largely devoted to unproductive purposes -- dangerously threatens to destabilize America's national savings system. As we have seen in the collapse of ESM Government Securities Inc., when major investors reach for higher yields without regard for security and safety of principal, the results can be disastrous."

The point, Mr. Chairman, is not that lower graded high-risk debt is bad. Quite the contrary. What is wrong, in our opinion, is the use of these investments in hostile takeovers. They allow corporate raiders to gain access to financing that requires asset liquidation to be successful; results in the substitution of debt for equity; and transfers the risk to the small shareholder and the average American, who may, through his savings account in a federally insured savings and loan, be participating unknowingly in these transactions.

One final point on the use of junk bonds in ho takeover attempts, Mr. Chairman, before I briefly addres areas of public policy more directly within the purview of this Committee. Under current law, investors are able to take an income tax deduction for interest paid on borrowed funds to finance stock or asset acquisitions. We do not take issue with the income tax deduction for interest paid, except as it applies to junk bonds when used in a hostile takeover. We believe, that since these "debt" obligations are subordinated to other debt of the corporation and because of the very low amount of equity made available to finance the typical hostile raid, junk bonds used in a hostile raid should not be treated as bonafide debt under the tax code. These instruments resemble equity more than debt and therefore the corporate raider -- intent on securing a tax-favored distribution of the target company's assets -- should not be allowed this tax deduction for their use.

The equity nature of these securities is apparent. As was recently stated (New York Times, April 14, 1985, page 8F),

> "...after a cash tender offer gives control to an acquirer, the buyout can be structured so that the remaining stockholders receive junk bonds of a lower quality or preferred stock, which is junior to any debt obligations. While the value of those

> securities may be equal to the cash received in the first portion of the tender offer, those securities are at the bottom of the totem pole: when it comes to collateral, they are behind most securities received by the original commitment group...In the event of bankruptcy, for instance, bank debt, senior bonds and notes and common stock have the first call on assets, ahead of most junk securities paid out to shareholders of the takeover company."

Thus, the junk bonds are virtually on a par with common stock -- at the "bottom of the totem pole."

Congress addressed a similar problem in 1969 over how to distinguish debt from equity in acquisitions. Then it enacted Section 279 of the Internal Revenue Code by limiting the interest deduction for certain convertible subordinated bonds used in corporate acquisitions. Congress decided that these bonds provided a "special and unwarranted inducement to mergers." The problem now is not convertible debt, but junk bonds.

Legislation has been introduced by Senators David Boren and Don Nickles (S.476) that would deal specifically with this issue by disallowing the interest deduction on junk bonds when used in a hostile acquisition and by imposing a 50% excise tax on greenmail profits. We support this legislation.

Mr. Chairman, my opening comment was that, in a nutshell, the basic problem with certain hostile takeover attempts was that they result in short-term profits at the expense of long-term performance which do not achieve the reinvestment requirements our society and our economy will need to continue to grow. Our point is that public policy should not help this process.

As independent, outside Board members, Mr. Laird and I believe the goals of public policy regarding corporate mergers and acquisitions should be to ensure that all shareholders are treated fairly and equally with full disclosure of all relevant information in a timely manner. Public policy should foster the free market, consistent with safeguards for competition. We should be driven by a desire to ensure that all sectors of our economy have an equal and fair chance in pursuing their interests and one (or more) is not disadvantaged by the application of public policy. Most importantly, existing laws should not encourage highly leveraged corporate takeover attempts, nor discriminate against some stockholders to the benefit of the raiders.

For example, we oppose the practice of greenmail where some shareholders are paid a premium price above the market by management for their shares. Corporate raiders are making millions of dollars, in fact, solely from greenmail without actually succeeding in their hostile takeover attempts.

These takeover attempts usually proceed as follows, Mr. Chairman:

As you know, under our current securities laws, an investor can acquire up to 5% of a company's outstanding shares before he is required to make this knowledge publicly known - through the SEC 13D filing. And he has 10 days, after reaching 5%, to make his filing - during which he may continue to acquire the target company's stock. Therefore, a corporate raider, seeking short-term gain through liquidation of the target company, can establish a coercive beachhead at an extremely low price in the stock before the public-at-large knows what has occurred or can evaluate the market. In our opinion, any accumulation of stock by the raider is material information which the other owners of the company should have. Lowering the threshhold for 13D filings and eliminating the ten-day period for disclosure would be a step toward treating all shareholders equitably.

Also, Mr. Chairman, these hostile takeover attempts usually proceed as two-tier offers -- the first being a cash offer for a percentage of the shares that will give the raider control -- followed by the second tier offer that usually consists of securities, including junk securities, for the balance. This system puts pressure on shareholders to tender with the first-tier offer or risk being offered a lower value in the second tier. Again, this process is not consistent with the public policy goal of equality of treatment for all shareholders and needs revision.

In our opinion,the Congress should consider whether there are certain features of the merger rules used in Great Britain that can be applied to our system. For example, as I understand it, offers to acquire 30% or more of a British company's shares are not normally permitted if the purchasor has acquired his shares during the preceeding 12 months and he does not propose to buy all the remaining shares for the best price he has paid for his shares accumulated over the previous 12 months. Such a procedure eliminates coercive two-tier offers and seems to ensure that all shareholders are treated fairly.

The final point I want to make Mr. Chairman, has to do with the Hart-Scott-Rodino Act, and its enforcement by the Federal Trade Commission. As you know, Hart-Scott-Rodino has procedures requiring persons to notify the FTC or the Department of Justice when acquisitions have occurred above certain threshholds. This law was enacted to provide the federal government with lead time to determine whether the contemplated acquisition raised antitrust concerns. It is apparent however, that the FTC is not rigorously enforcing Hart-Scott-Rodino when "partnerships" are created to serve as the acquiring vehicle. In fact, during testimony on April 16, before the House Energy and Commerce Committee's Subcommittee on Commerce, Transportation, and Tourism, James Miller, Chairman of the FTC and Timothy J. Muris, Director of the FTC's Bureau of Competition agreed that their own rules need clarification in this regard. I believe that the Senate

Judiciary Committee should follow-up on this, Mr. Chairman, and hold oversight hearings on this matter. Today, corporate raiders, creating shell partnerships solely for acquisition purposes are avoiding the notification requirements and the intent of the law. Congress should determine why this is occuring and take appropriate corrective action.

In conclusion, Mr. Chairman, I want to make it clear that, as independent outside Board members, we see reason to be concerned over these hostile corporate raids that target strong companies, with the intent to profit in the short term from their dismantlement. As I said in my opening comment, this is the source of the abuse -- not the normal mergers and acquisitions occurring in the marketplace that have sound financial backing and that foster long term economic growth. Again, I am an ardent supporter of the American enterprise system and I make these recommendations for your review of these matters only after personal experiences with loopholes in the system. We believe, Mr. Chairman, that this Committee and the Congress can selectively amend appropriate federal laws and their implementing regulations to correct this problem.

I want to close by quoting from testimony given by Martin Lipton before the Senate Banking Committee's Subcommittee on Securities on April 3, 1985. He characterizes the hostile takeover phenomenon as follows:

The problem "...is the bust-up takeover and the extre leverage that is being built into the structure of American business. While different in form, what we face today is not different in substance from what happened in 1928 and 1929. Leverage produces great results on the way up, but no economy ever goes up in a straight line and high leverage inevitably produces a crash when an economy turns down.

It is clear that abuse of the corporate takeover process has become a serious problem and is a threat to the economic system of the United States. On the other hand, as the takeover entrepreneurs have grown more aggressive, corporations have been forced to respond with defensive mechanisms to match them..."

The problem arises, as Mr. Lipton says, because of an abuse to the free enterprise system. Some sharp raiders and speculators have taken advantage of the system to enrich their pockets at a cost to this country's productive might, its national security, and its sense of fairness. This is the crux of the entire situation.

Thank you Mr. Chairman, I would be happy to answer any questions you or Members of the Committe might have.

April 23, 1985

Subcommittee on Taxation and Debt Management
Senate Finance Committee
c/o U. S. Senate
Washington, D. C. 20510

Senate Judiciary Committee
c/o U. S. Senate
Washington, D. C. 20510

Subcommittee on Telecommunication, Consumer
Protection and Finance
House of Representatives Committee on
Energy and Commerce
c/o U. S. House of Representatives
Washington, D. C. 20515

Gentlemen:

By way of introduction, I am a Patent Attorney, employed by Phillips Petroleum Co. I have served in this capacity, as a Staff Attorney, in middle management and as a private practitioner for nearly 35 years. Substantially all of this time has been spent representing member corporations of the Oil Industry.

While my background limits my knowledge, to some extent, primarily to the fields of Oil Industry affairs and Research and Development, hostile takeover activities in the past several years have shocked my sensibilities and convinced me that something must be done, and done with all due speed, to put an end to this activity for the future well-being of the nation as a whole. Therefore, I respectfully request that you consider the following thoughts in your deliberations.

Mr. Boesky has been quoted as saying, 'ten men (hereafter referred to as the "Tender Ten") control the entire corporate structure of this country.'

Incredible? - hardly. As Art Buchwald's Little Red Riding Hood told Amalgamated Wolf, "Size means nothing. The only thing that counts is how much money I can raise to get control."

Something is radically wrong when ten self-appointed keepers of the consciences of corporate managements, champions and protectors of the "real owners" and architects of the "restructuring" of industries can wield this kind of power. Something is also very wrong when such a person can, with the wave of a hand (full of funny money), destroy, in less than a year, what has taken others decades of blood, sweat and tears to build. In the world of hostile takeovers, a briefcase full of cut-up newspapers, sandwiched between two pieces of legitimate currency, has replaced the cutlass.

We urge Mr. Pickens to ask the ex employees of Gulf, Cities Service, Superior and Getty, the future ex employees of Phillips and Unocal and the legitimate shareholders of the "white knights", who "saved" most of these, how amusing they find it that "---a little guy from Amarillo can make three big guys duck for cover---". Making light of an activity, which jeopardizes the lives of people, corporations, industries and communities and misdirects the free enterprise system and the corporate structure, the energy policies, the balance of payments and the economy of this nation, is a sick joke at best.

Tami Simic of W. T. Grimm & Co. has stated, "The company exists to make a profit for shareholders --- not to provide employment."

It is possible to have a corporation with assets and no employees. However, assets lying fallow and collecting dust, cobwebs and moss do not make a profit. Money-making machines are illegal and no one has yet invented a perpetual motion machine. Therefore, a perpetual motion, money-making machine is an illegal non-entity and a corporation should not be so labeled.

Unfortunately, this theory is used as a crutch for the activities of the Tender Ten, their financial arrangers and financial institutions who aid and abet them.

Sight is completely lost of the underlying principles which gave rise to the public sale of stock and created the stockmarket, which these individuals and institutions are now manipulating, solely for their own profit and to nourish gigantic egos.

No one can deny that the "Family" corporation is no longer capable of providing the products and services demanded by the peoples of the world, maintaining employment at acceptable levels, adequately supporting the economy and competing for world trade. Nor can anyone seriously argue that a corporation can grow beyond a parochial curiosity by borrowing capital on its assets alone and without the public issuance of stock. Legitimate shareholders invest in the assets of the corporation and the abilities, industry and ingenuity of its employees, with the thought that they will receive some interest on their investment (dividends) and that their investment will grow with the corporation over the long run - not to make a fast buck by the sale of the company's assets and its consequent liquidation.

In today's world, a corporation is not an island unto itself, but, its purpose is to serve all of its constituents - customers, suppliers, employees, shareholders, debt holders and affected communities - in a balanced way. Imbalances among these constituencies do occur. However, these groups, operating in an unmanipulated, free market, quickly get the message to the company and imbalances have been corrected in the past by corporations, without any help from the saviors of the system.

No one has elected or appointed the Tender Ten to oust inept, weak, inefficient or self-serving managements of companies, to "enhance" the value of the stock, to obtain "fair" value for all stockholders or to "restructure" the oil or any other industry.

Members of the Tender Ten have proclaimed: "Our intention was to acquire the Company and to take it private through a full leveraged buyout. As we stated repeatedly, we would move to Oklahoma and operate Phillips from its Bartlesville headquarters." "We fully intend to operate the Company and maintain *a* major headquarters in Bartlesville." "We love Bartlesville, we love all the employees and Phillips Petroleum." "We damn well want to take over one of these companies---. We're sincere about it."

They should slip in some of the stuff which characterizes these pronouncements. However, that is unlikely, since the Tender Ten have proven themselves quite adept at kicking sand over detrimental facts and sidestepping issues which might create "social problems".

In spite of these expressed intentions, hardly a day goes by that a press release, an interview, a speech to the "Dogcatchers of America" or an SEC filing is not utilized to convey messages that - they would "step aside" if the target company would only raise its stock price to near the "appraised" value or that plans *could* include restructuring, such as, stock repurchase by the company, recapitalization of the Company or *sale or distribution of its assets*. What would happen to the writer if he handed out a press release or stated in an interview or speech (intended to be published), "I intend to take over your wife and sell her to the highest bidder."? Patents cannot be obtained for innovative methods of extortion and blackmail nor can these be changed in character by painting them green.

Innovative methods of deficit financing are also unpatentable, but the Tender Ten must be given an "A" in this area. Mr. Pickens has stated "Can you see me going into a bank and saying, 'I want to borrow on Phillips assets?' They'd throw me out." Can you see the writer going into a bank and asking to buy a car with a down payment of less than 5% and the car as security, with the bank having full knowledge that the only way I can pay off the loan is by selling the car piece by piece, that there is no market for all the pieces and the market value of others is well below the "appraised" value? Yet Mr. Icahn would sell at least one refinery, when the market for refineries is equal to the market for houses in Bartlesville - zero. It might also be urged that the "real owners" of Mesa "revolt". It is doubtful that the "activities", for which the company's management voted one of its own a $27MM bonus, are purposes stated in the Company charter or by-laws. Their meager assets are also being put "at risk" while they receive $18MM for their investment in the same period. They won't, because there is no risk, the rate of return is astronomical and the return is fast.

The above raises the further question of whether the actions of the lending institutions, who support these activities, border on fraud on their stockholders and depositors. No - because the lenders remind them it's a good investment - they can't lose. A number of these financiers readily admit they make "commitments" knowing they will never actually have to make the loan. In the meantime, they collect obscene interest, on relatively small amounts actually loaned, and commitment "fees" - all in a short period of time.

Martin Lipton, of Wachtell, Lipton, Rosen and Katz, aptly summarized these financing methods as " --- two-tier, front-end loaded, boot-strap, bust-up, junk bond takeovers."

The Tender Ten declare ad nauseum that their "services" are necessary and vital and "benefit" stockholders, consumers, the economy and the nation. Mother Goose and Grimm (no relation of W. T. Grimm) would be green with envy if they read the explanations of why this is so.

Member companies of the Oil Industry always have had and always will have "undervalued" stock. Finding and producing oil requires a substantial amount of high-risk capital and oil companies have always been in the forefront in supporting research and development. Competition in both has also been keen. Neither of these produces short term profits.

The value of energy independence needs no comment, even though some, in referring to foreign oil say, "---if it's cheap, use it---".

Innovation and ingenuity have made this country the dominant industrial power that it is. However, that edge is rapidly eroding and this loss is contributing greatly to the declining ability of the nation to compete in the world market. A quick, although partial, indication of this can be garnered by a review of the substantial and rapidly increasing number of patents issued to foreign corporations by the U. S. Patent Office.

Yet the Tender Ten is forcing the oil industry to concentrate on short term profits, and research and oil exploration are the first which must be eliminated or reduced. The "white knights" of the industry have been forced to drastically reduce exploration expenditures and Phillips is trying to simply hold the line. The research departments of most of the "rescued" companies have been eliminated, the reductions in the research budgets of the rescuers cannot be documented, but exist, and Phillips has reduced research, with more to come. Competition has been drastically reduced in these two areas alone.

The benefits to consumers simply have not appeared.

I cannot compete with Mr. Pickens in the trivial pursuit of numbers representing the "benefits" he has allegedly obtained for stockholders. Few legitimate stockholders, of the victim companies, can beat the remaining members of the Tender Ten and institutional holders to the cash portion of a tender offer. Some do, but all are forced to try for the quick "profit" at the expense of their long term benefits - simply to salvage what they can. Left out of the formula are the shareholders of the heavily-debted companies who rescued the victims.

It is obvious that a great deal more sleep is lost by the Tender Ten over the prospect of actually succeeding in a takeover than over the plight of the other shareholders and the greed of the vast number of inept managements pillaging the countryside. It must be frightening to face the prospect of having your "seed" money tied up in a company loaded down with a debt in excess of 90% of its assets. A "fire sale" or "going out of business" sale is the only answer. But then you find out what assets actually have a market and what their real value is. The more frightening prospect is to be forced to operate the company, with little or no experience, and make money the hard way - earn it.

Also left out of the formula are people, who are the biggest asset of any corporation, and the communities dependent on these employees and the company. Thousands of employees of the victims of the Tender Ten (estimated by most at 20 to 25%) have been terminated (in more ways than as employees), and the numbers for Phillips and Unocal are yet to be counted. DuPont, who rescued Continental, is offering sweetened early retirements. Offices of Gulf, Cities, etc. have been closed all over the country.

These tragedies which result from takeovers are simply "---characteristic of a dynamic economy and a free enterprise system", according to Ms. Simic.

Large sums of money are wasted in takeover attempts and defending against them and a great deal of credit is tied up by the Tender Ten, attempts to ward off their onslaught and by the surviving companies, all of which is badly needed for productive activities and furthering innovation. This benefits the economy?

These activities may have "redeeming social value" to the Tender Ten and their wives and families, but, the benefits to anyone or anything else escape me.

Ms. Simic further opines that "---corporations can adopt anti-takeover measures by amending their by-laws." Mr. Pickens demurs - "No poison pill or shark repellant yet devised can insulate a company from acquisition---". Exxon, Sun, Arco and others are making huge purchases of their own stock, with money which, again, could be used for more productive purposes. An interesting question could be asked at this point. After the domestic oil industry is restructured, which should not take more than two or three more years, where to then - Saudi Arabia? It's grossly "undervalued", it's run by an "entrenched" management and the "real owners" (the citizens) have not received "fair value" (from the sale of the country's assets).

Intelligent people have, at times, suggested that those who stayed and fought "won". It's difficult to visualize the bloodied fighter, who leaves the ring with his brains addled, his future as a competitor diminished and a piece of paper obligating him to pay his opponent's training expenses and the expenses for promoting the fight, as the "winner", when his unmarked opponent leaves with all the gate receipts - laughing all the way to the bank.

The sum and substance of the above is that no one wins except the Tender Ten, their "arrangers" and "gamblers" who make it all possible with loans and empty commitments. Somewhere along the line there is going to be one hellacious explosion scattering debris over every facet of the economy - when a "sure thing" doesn't materialize. Waiting until it happens will not solve the problem - the Tender Ten will not fade away. In fact, fast, risk-free, big money from a small investment,will not elude more participants, savory or unsavory, for long.

Murder and rape are not condoned by civilized society because the murderer or rapist unilaterally decided the victim needed "restructuring", the victim's "managers" were not receiving "fair value" or the victims "entrenched" parents were "immoral", "greedy", "self-indulgent", "inept", "weak" or "inefficient". Likewise, "corporate murder" and "corporate rape" cannot be condoned because the Tender Ten unilaterally decide it needs to be done.

Passage of pending legislation to place a moritorium on hostile takeovers, until thorough studies can be made and appropriate legislation passed, and to remove tax incentives from these activities is strongly urged. Mr. Pickens disagrees, "I don't want any anti-merger or anti-takeover legislation---and I don't think we're going to have any". The insufficiency of this legislation is also pointed out by Mr. Pickens, who says that "tax consequences" are not considered in deciding on a takeover attempt. After all, a fast half-buck or quarter-of-a-buck should be just as attractive - all you do is set your sights higher.

Enforcement of existing laws would help.

Full disclosure at the outset, of exactly what is intended, exactly how it is to be financed and exactly what is to be done with the corporation's assets and operations should be required (applying stickum in the dressing room after the game is lost is ludicrous) - with appropriate penalties for variances or at least prior approval of variances.

Prostitution of lending institutions can, at least, be slowed, by requirements that all of the stock purchased in a hostile takeover be secured by the assets of the perpetrator of the takeover.

Finally, all stock in the target company should be held for a minimum period prior to a tender offer taking effect - measured in terms of years not days. This would not only afford the legitimate shareholders sufficient time to analyze the value of the offer but it would legitimize the offeror, as a stockholder, and give him time to learn something about the industry he alleges he wants to operate in and the company he says he wants to operate. As things now stand, the Tender Ten are complete strangers to the Company and its shareholders prior to setting the combine in motion and they become complete strangers again when the harvest is completed. None of the Tender Ten is in line to invest in the future of Chevron, Texaco, etc. and Mr. Pickens is shedding no tears at not being able to buy stock in Phillips. The best that's been offered is 'lots-a-luck! ' - "I sincerely hope Phillips management will succeed in its efforts to ensure that the company becomes a viable and profitable competitor in the years ahead". (emphasis added). And, inept management turns "ept".

The above is bitter medicine to the writer, who learned the word "laissez-faire" in Economics I and has been enamoured with it ever since. But, it is immeasurably more palatable than having the free enterprise system degraded, people, corporations, industries and the corporate structure destroyed, and the economy, the energy independence and the balance of payments of this country emaciated by a commission of self-proclaimed regulators. There is also a substantial difference between laws designed to accomplish "social engineering" and those designed to stop activities which utilize loopholes in existing laws, "trip the light fantastic" between legal and illegal and can logically lead to illegal or criminal activity.

Suggested reading is Art Buchwald's columns entitled "Phillips: A Lesson in Greenmail" and "Little Red Goes to Wall Street." These pieces are necessarily satirical but are the most insightfull and factual commentaries on the subject I have had the privilege of reading.

It is respectfully requested that this letter be made a part of the Subcommittee's record. To the best of my knowledge, few, if any, representatives of labor and individual employees have been heard from - only the willing and unwilling players in this sadistic game of "Russian Roulette".

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